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BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the 2009 Annual Filing of Columbus Southern Power Company And Ohio Power Company Required by Rule 4901:1-35-10, Ohio Administrative Code	)))))	**Case No. 10-1261-EL-UNC**

INITIAL BRIEF OF COLUMBUS SOUTHERN POWER COMPANY AND OHIO POWER COMPANY

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INTRODUCTION

Because the SEET statute, Section 4928.143(F), Revised Code, offers virtually no guidance as to its proper application, it is barren of any practical meaning and violates both prongs of the void-for-vagueness doctrine. The terms used in the SEET statute are very broad and general. No definitions, standards or guidance is provided to give the EDUs fair notice of their risk of forfeiture or to give the Commission adequate standards to appropriately judge the result. As is evident by the parties' starkly conflicting positions in this case, the statute has left the parties to speculate as to what constitutes significantly excessive earnings and has failed to properly inform the exercise of the Commission's discretion. The vagueness of R.C. 4928.143(F) is further compounded by the fact that the statute applies in a retrospective manner, requiring an EDU to forfeit earnings from a prior year. Given the harsh, asymmetrical consequences leveled by a finding of significantly excessive earnings, and the burden on the EDU to prove that their earnings were not excessive, the General Assembly had a heightened obligation to assure that an EDU had fair notice *in advance* of how its earnings would be measured and judged and to assure that the Commission had clear direction on how the test was to be administered. The General Assembly failed to meet its constitutional duty in this instance and the statute is unconstitutionally vague. Because the Commission failed to cure the vagueness of the statute when it had the opportunity to do so in the AEP-Ohio ESP cases and in the SEET investigation case, its only recourse now is to ameliorate the consequences of the statute's constitutional infirmity by following the path laid out by the Companies' witnesses, which assures that the Companies will not be wrongfully deprived of their property.

The Companies retained Dr. Anil K. Makhija to develop a methodology that implements the significantly excessive earnings test. Dr. Makhija's methodology for establishing an appropriate 2009 return on equity threshold for the SEET applicable to CSP and OPCo has two basic components. The first component of his recommended methodology, involves identifying the group of firms with comparable business and financial risks, the Comparable Risk Peer Group, using well-established metrics. Measuring the earned rates of return on equity (ROEs) of the Comparable Risk Group as normal earnings on average common equity, he obtained that group's mean earned ROE, which is 11.04%.

The second basic component of Dr. Makhija's methodology, is to determine the additional amount that, when added to the baseline ROE, establishes the SEET ROE Threshold. Makhija recommends defining the ROE Threshold as the mean ROE for the Comparable Risk Peer Group plus 1.96 times the standard deviation of the ROEs for the Comparable Risk Peer Group. It is against this ROE Threshold that the ROEs for CSP and OPCo for 2009 should be compared. Dr. Makhija concludes that the 1.96-standard deviation adder employed to construct the ROE Threshold, which corresponds to a 95% confidence level, is appropriate because (1) it is the established practice to use that confidence level, and (2) because it provides for a reasonably acceptable risk of false positives. Dr. Makhija concluded that his methodology is an appropriate approach for establishing the SEET ROE Threshold for several very compelling reasons. Dr. Makhija also pointed out that the use of statistical methods, such as those that he recommends using, does not supplant the role of judgment or reduce the SEET to a mechanical exercise.

Companies witness Mitchell addressed the appropriate method for calculating each Company's earned return on common equity (ROE) including deductions for Off-System Sales (OSS). Mr. Mitchell implemented the Companies' recommendation, supported by Companies witness Hamrock, to adjust the Companies' earned ROEs by subtracting the OSS net margins (after federal and state income tax) from the net earnings available to common shareholders. There are two primary reasons that support adjusting the Companies' earned ROEs by subtracting OSS net margins. First, Section 4928.143(F), Revised Code, specifically provides that only earnings resulting from adjustments included in the EDU's ESP are subject to the SEET, and OSS earnings are not the result of an ESP adjustment. Second, as set forth in more detail below, 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 being subject to refund under the SEET statute. In sum, CSP's Electric Security Plan does not include a rate adjustment for OSS margins and it would be unfair and bad regulatory policy to subject OSS margins to being clawed back under the SEET statute.

Since OPCo's 2009 earned ROE of 9.42% is less than the safe harbor limit suggested by any of the witnesses in this proceeding, OPCo's 2009 earned ROE should not be subject to further SEET analysis. CSP's 2009 earnings are not above the appropriate 2009 ROE threshold and the Commission should not make a finding that significantly excessive earnings existed for CSP in 2009. Based on Dr. Makhija's ROE threshold recommendation of 22.51%, there are no significantly excessive earnings either based on CSP's earnings that exclude OSS margins of 18.31% or its unadjusted, per books, earnings of 20.84%.

Customer Group witness Kollen spends considerable effort in his testimony making irrelevant ROE comparisons. Specifically, Mr. Kollen compares CSP's return to four different groups: (1) other Ohio electric utilities, (2) other AEP-East operating companies, (3) regulated investor-owned electric utilities in the United States, and (4) traditional rate case decisions in 2009 involving electric utility companies. Each of these comparisons is irrelevant as a matter of law and should be disregarded.

As discussed in AEP Ohio witness Hamrock's testimony, the Companies submit that it is inappropriate for the Commission to consider refunding earnings based on revenue that has not actually been collected from customers. (Cos. Ex. 6 at 13.) If the Commission uses a different ROE threshold and/or uses a different earned return in applying the SEET statute, then the Commission might also need to exclude the "paper earnings" associated with CSP's deferred fuel and economic development earnings – this approach further reduces CSP's 2009 earnings to 15.99%. Whether the Commission needs to exclude the deferrals depends on what ROE threshold it adopts and what 2009 earnings for CSP are used in applying the SEET statute.

The scope of the SEET under R.C. 4928.143(F) extends only to significantly excessive earnings resulting from rate increases included in an approved ESP. The earnings from ESP adjustments potentially subject to a remedy/return to customers are limited to: tariff rate increases, authorized by the ESP, paid by customers during 2009, and that directly produced earnings (*i.e.*, not ESP adjustments that simply provide for the recovery of costs). Rate adjustments that merely pass through costs incurred do not provide new earnings opportunities for an EDU. The Commission's June 30 Finding and Order also found (at pages 14-15) that "the clear, unambiguous language of the statute limits the amount of any refund to customers to the adjustments in the current ESP." Again, the Commission (at page 15) directed electric utilities to include in their SEET filings the *difference in earnings* between the ESP and what would have occurred had the preceding rate plan been in place.

The statutory language in Section 4928.143(F), Revised Code, also provides the Commission with flexibility to consider the EDU's upcoming capital requirements when determining whether significantly excessive earnings exist. Specifically, the statute gives the Commission the latitude to determine that if the EDU has capital spending commitments that it must meet in the near future, its earnings should not be considered significantly excessive. That language would also allow the Commission to permit an EDU to retain earnings that might otherwise be considered to be significantly excessive, under the implied theory that the EDU could use them to meet its capital spending requirements for the future committed investments. AEP Ohio submitted evidence of its $1.67 billion capital investment in Ohio during the ESP. Specifically, even beyond the substantial level of "normal" investment committed by CSP (totalling at least $641.4 million during the ESP), CSP has also committed to make exceptional incremental capital investments in Ohio involving a large solar farm (*e.g.*, a $20 million equity investment), substantial environmental investments and expansion of its gridSMART initiative. All of these capital commitments should be considered by the Commission as necessary to avoid a finding of significantly excessive earnings for CSP in 2009.

BACKGROUND

An electric distribution utility (EDU) operating pursuant to an ESP with a term of three years or less is subject to an annual test, in accordance with Section 4928.143(F), Revised Code, to determine whether it had significantly excessive earnings during the prior year. That section (sometimes referred to in this brief as the "SEET statute") provides in pertinent part as follows:

> 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 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 including utilities, that face comparable business and financial risk, with such adjustments for capital structure as may be appropriate, consideration also shall be given to the capital requirements of future committed investments in this state. The burden of proof for demonstrating that significantly excessive earnings did not occur shall be on the electric distribution utility. If the commission finds that such adjustments, in the aggregate, did result in significantly excessive earnings, it shall require the electric distribution utility to return to consumers the amount of the excess by prospective adjustments . . . .

Rule 4901:1-35-03(C)(10)(a), Ohio Admin. Code, sets forth the annual SEET filing requirement, providing in pertinent part that "the electric utility shall provide testimony and analysis demonstrating the return on equity that was earned during the year and the returns on equity earned during the same period by publicly traded companies that face comparable business and financial risks as the electric utility." In Case Nos. 08-917-EL-SSO and 08-918-EL-SSO the Commission approved an ESP with a three-calendar-year term of 2009 through 2011. Consequently, the first annual period of AEP Ohio's ESP to which § 4928.143(F)'s SEET applies is calendar year 2009. The Commission issued a Finding and Order on June 30, 2010 ("June 30 Finding and Order") and an Entry on Rehearing on August 25, 2010 ("August 25 Entry on Rehearing") in Case No. 09-786-EL-UNC that addressed certain aspects of, and deferred addressing other aspects of, the 2009 SEET filings of the electric distribution utilities' (EDUs).

There are three basic steps to begin applying the SEET to CSP and OPCo for 2009. First, the average earned return on equity (ROE) during 2009 by publicly traded firms with business and financial risks comparable to those that CSP and OPCo face must be calculated. Second, the level above the average earned ROE of the comparable risk group of firms, at which point the earned ROEs may become significantly excessive, must be determined. Third, CSP's and OPCo's earned ROEs for purposes of the 2009 SEET must be determined. Once those calculations are made, a comparison can be made between the significantly excessive earnings test benchmark and CSP's and OPCo's earned ROE for the 2009 SEET. For AEP Ohio's 2009 SEET filing, Companies witness Dr. Makhija performed steps one and two in his testimony and Companies witness Mitchell performed the calculations to support Companies witness Hamrock's application of the third step in his testimony.

As further discussed below, the results from these three initial steps are used to further evaluate whether significantly excessive 2009 earnings exist for CSP and OPCo. Most important among these factors, the SEET statute requires that the Commission consider the capital requirements of future committed investments. In addition, the Commission's June 30 Finding and Order indicated (at 29) that the Commission would also consider: (1) the electric utility's most recently authorized return on equity; (2) the electric utility's risk, including whether the electric utility owns generation, whether the ESP includes a fuel and purchased power adjustment or similar mechanism, the rate design and the extent to which the electric utility remains subject to weather and economic risk; (3) indicators of management performance and benchmarks to other utilities; (4) innovation and industry leadership with respect to meeting industry challenges to maintain and improve the competitiveness of Ohio's economy, including research and development expenditures, investments in advanced technology and innovative practices; and (5) the extent to which the electric utility has advanced state policy.

On September 1, 2010, CSP and OPCo initiated this proceeding by making their annual SEET filing under Rule 4901:1-35-03(C)(10)(a), O.A.C., relative to 2009 earnings. Written testimony was filed and an evidentiary hearing was conducted in this case. The parties are now submitting their briefs based on the record for the Commission's consideration and decision in this case. In the event the Commission orders a refund, the SEET statute provides that the affected electric distribution utility has the right to terminate the ESP upon making the refund. (Section 4928.143(F), Revised Code.)

ARGUMENT

I. R.C. 4928.143(F) IS VOID AND UNENFORCEABLE BECAUSE IT IS IMPERMISSIBLY VAGUE AND FAILS TO PROVIDE CSP AND OPCo WITH FAIR NOTICE, OR THE COMMISSION WITH MEANINGFUL STANDARDS, AS TO WHAT IS MEANT BY "SIGNIFICANTLY EXCESSIVE EARNINGS."

a. The void-for-vagueness doctrine

The Due Process Clauses of the Fifth and Fourteenth Amendment give rise to the void-for-vagueness doctrine. The doctrine has two primary goals. The first goal is to ensure "fair notice" to those subject to the law as to what the law requires; the second is to provide standards to guide the discretion of those charged with enforcing the law. *Columbia, Natural Resources, Inc. v. Tatum*, 58 F.3d 1101, 1104 (6th Cir. 1995). The Supreme Court has defined the first goal with greater specificity by holding that "[a] statute which either forbids or requires the doing of an act in terms so vague that men of common intelligence must necessarily guess as to its meaning and differ as to its application, violates the first essential of due process of law." *Id.* at 1105 (citing *Connally v. General Constr. Co.*, 269 U.S. 385, 391, 46 S. Ct. 126, 70 L.Ed 322 (1926)). The second goal "relates to notice to those who must enforce the law . . . . [t]he standards of enforcement must be precise enough to avoid 'involving so many factors of varying effect that neither the person to decide in advance nor the jury after the fact can safely and certainly judge the result.'" *Id.* (citing *Cline v. Frink Dairy Co.*, 274 U.S. 445, 465, 47 S.Ct. 687, 71 L.Ed. 1146 (1927)).

Although the vagueness doctrine arises most often in the context of criminal laws that implicate First Amendment values, "vague laws in any area suffer a constitutional infirmity." *Ashton v. Kentucky*, 384 U.S. 195, 200, 86 S.Ct. 1407, 16 L.Ed.2d 469 (1966) (collecting cases at n. 1). See also, *Cline*, 274 U.S. at 463 ("The principle of due process of law requiring reasonable certainty of description in fixing a standard for exacting obedience from a person in advance has application as well in civil as in criminal legislation.") Laws that impose criminal penalties or sanctions or reach a substantial amount of constitutionally protected conduct, however, must satisfy a "higher level of definiteness." *Belle Maer Harbor v. Charter Township of Harrison*, 170 F.3d 553, 557 (6th Cir. 1999);

Belle Maer Harbor, for example, involved a township ordinance that regulated the use of mechanical agitators ("bubblers") to clear the surrounding waterway of ice. A marina operator challenged the ordinance on vagueness grounds because it empowered enforcement officials to determine whether the area of open water created by the agitator was within a "reasonable radius" around the protected object. The lower court upheld the ordinance. The Sixth Circuit disagreed, finding it unconstitutional. The appellate court applied a heightened scrutiny standard – requiring a "high level of definiteness" – because violation of the ordinance carried criminal penalties:

> This court does not disagree with the Township that many ordinances, statutes and other enactments have "gray areas" requiring the use of an officer's discretionary judgment in their enforcement. However, due process requires at least sufficient exactness to prevent arbitrary enforcement and give notice of what an individual must do to comply with the enactment. . . . Under the present scheme, neither the enforcement officer nor the bubbler operator can ascertain by examining the language of the Ordinance alone whether criminal sanctions will result from one foot or ten feet of open water created by a bubbler around a protected object. This level of imprecision cannot withstand a due process challenge on vagueness grounds.

Id. at 559. See also *Connally v. Gen. Const. Co.*, 269 U.S. at 393-95 (holding state statute requiring state contractors to pay the "current rate of per diem wages in the locality" void for vagueness); *Cline v. Frink Dairy*, 274 U.S. at 465 (state anti-trust statute held void for vagueness).

The Ohio Supreme Court re-affirmed and clarified the void-for-vagueness doctrine in *Norwood v. Horney*, 110 Ohio St.3d 353, 2006-Ohio-3799. The court struck down a municipal ordinance that allowed private property in a "deteriorating area" to be taken by eminent domain, even though the municipal code set forth "a fairly comprehensive array of conditions that purport to describe a 'deteriorating area.'" *Id.* at ¶

93. The Court applied the heightened scrutiny standard even though the statute carried no penalties or sanctions because the eminent domain power "necessarily entails the state's intrusion onto the individual's right to garner, possess and preserve property." *Id.* at ¶ 88. The Court held:

> In the cases before us, we cannot say that the appellants had fair notice of what conditions constitute a deteriorating area, even in light of the evidence adduced against them at trial. The evidence is a morass of conflicting opinions on the condition of the neighborhood. Though the Norwood Code's definition of 'deteriorating area' provides a litany of conditions, it offers so little guidance in application that it is almost barren of any practical meaning.
>
> In essence, deteriorating area is a standardless standard. Rather than affording fair notice to the property owner, the Norwood Code merely recites a host of subjective factors that invite ad hoc and selective enforcement – a danger made more real by the malleable nature of the public-benefit requirement.

Id. at ¶¶ 97-98.

b. Application of the doctrine to Section 4928.143(F), Revised Code

Like the eminent domain ordinance in *Norwood v. Horney*, the statute here results in the taking of private property rights. R.C. 4928.143(F) requires an EDU to disgorge or forfeit earnings it lawfully gained through the efficient use of its own property so that those earnings can be re-distributed to its customers, even though the customers indisputably paid a just and reasonable price for the service they received. As such, as in *Norwood*, the statute must satisfy "heightened standard of review employed for a statute or regulation that implicates a First Amendment or other fundamental constitutional right." *Norwood* at ¶88. As well illustrated by the record in this case, Section 4928.143(F), Revised Code, cannot withstand this scrutiny either on its face or as applied herein.

The statute on its face fails to give any definitive notice or guidance whatsoever as to what is meant by "significantly excessive earnings." As a result, as the Commission has recognized, "there are many different views concerning what is intended by the statute and what methodology should be utilized." *In re Columbus Southern Power Company and Ohio Power Company*, Case No. 08-917-EL-SSO, et al., Opinion and Order at 68 (March 18, 2009). The SEET statute is far more deficient than the ordinance at issue in *Norwood*, which provided a "fairly comprehensive array of conditions that purport to describe a 'deteriorating area,' including . . . incompatible land uses, nonconforming uses, lack of adequate parking facilities, faulty street arrangement, obsolete platting, and diversity of ownership." *Id.* at ¶93. If "deteriorating area" is a "standardless standard," *Norwood* at ¶ 98, notwithstanding the comprehensive listing of descriptive conditions in the ordinance, the SEET, which makes no attempt to define its terms or explain the intended methodology, is an all the more egregious violation of the void-for-vagueness doctrine.

Section 4928.143(F), Revised Code, also is far more deficient than the administrative provisions interpreting the Real Estate Settlement Practices Act struck down in *Carter v. Welles-Bowen Realty Inc.*, __ F. Supp.2d __. 2010 WL 2607266 (N.D. Ohio 2010). In *Carter*, the court invalidated a policy statement issued by the Department of Housing and Urban Development that described a ten-factor test for distinguishing between "sham" and "bona fide" providers of settlement services. The court found the test unconstitutionally vague because "half of the factors use vague terms reminiscent of the 'reasonableness' language struck down in *Belle Maer*," which invite a "highly subjective evaluation." *Id.* at *6. The court noted, among other things, that the HUD test gave no guidance "as to what level of capital would be deemed 'sufficient,' how many services must be performed to be deemed 'substantial,' what 'reasonable' rates are, or what an entity must do to 'actively compete.'" *Id.* The court concluded that because of the lack of meaningful definitions or standards in the ten-factor test "any entity wishing to operate as an [affiliated business arrangement] (an arrangement RESPA specifically condones with certain limitations) is thus confronted with a massive gray area." *Id.*

If the HUD ten-factor test left settlement service providers in a "massive gray area," the SEET in comparison throws EDUs into a black hole. The terms used in the statute are very broad and general. No definitions, standards or guidance is provided to give the EDUs fair notice of their risk of forfeiture or to give the Commission adequate standards to appropriately judge the result. As is evident by the parties' starkly conflicting positions in this case, the statute has left the parties to speculate as to what constitutes significantly excessive earnings and has failed to properly inform the exercise of the Commission's discretion. The parties have no common understanding of what level of earnings should be deemed "significantly excessive." They even diverge on the meaning of the factors to be used in this analysis, such as the scope of the "adjustments" to be measured in determining excess earnings, whether off-system sales should be included in the net earnings used to calculate the return on equity, how write-offs and deferrals should be treated, how to identify companies that face "comparable business and financial risk," or what is meant by the reference to "adjustments, in the aggregate."

The vagueness of R.C. 4928.143(F) is further compounded by the fact that the statute applies in a retrospective manner, requiring an EDU to forfeit earnings from a prior year; by the fact that it imposes on the EDU the burden of proving its earnings in the prior year were not significantly excessive; and by the fact that it penalizes an EDU for excess earnings in the prior year but does not insulate the EDU from prior year earnings that may fall significantly below what was earned in the same period by companies with comparable business and financial risk. The asymmetric burden of the SEET gives the statute a punitive nature and also may result in a Takings Clause violation. *City of Marietta v. Pub. Util. Comm.*, 148 Ohio St. 173 (1947). Without the SEET adjustment, surplus earnings from a prior year would remain available to offset deficient earnings in a later year. The SEET takes significantly excessive earnings away, without giving the EDUs an alternative for replenishing these earnings if needed in subsequent years.

As a related matter, the existence and extent of an EDU's potential SEET penalty is determined by the actions of third-parties beyond its control that cannot be ascertained or determined until after-the fact (*i.e.*, the earnings produced by a comparable risk group of firms based on their management decisions and in light of the circumstances faced by those businesses). Given the harsh, asymmetric consequences leveled by a finding of significantly excessive earnings, and the burden on the EDU to prove that their earnings were not significantly excessive, the General Assembly had a heightened obligation to assure that an EDU had fair notice *in advance* of how its earnings would be measured and judged and to assure that the Commission had clear direction on how the test was to be administered. The General Assembly failed to meet its constitutional duty in this instance.

The Commission had the opportunity to cure, or at least ameliorate, the effects of the statute's vagueness, but it too has failed to do so. In the AEP-Ohio ESP cases, the

Companies pointed out the uncertainty in the SEET and asked the Commission to give them the fair notice to which they were constitutionally entitled. See Case N0. 08-917, Cos. Reply Brief at 132-34. The Commission initially recognized the importance of giving the Companies the requested advance clarification at least with respect to OSS and deferrals, Case No. 08-917, Finding and Order at 69, but then inexplicably reversed itself even as to these two issues, ensuring that the Companies would receive no advance notice as to how the SEET would be administered. Case No. 08-917, Entry on Rehearing at 49 (July 23, 2009). The workshop proceeding which was intended to bring clarity to the statute did not conclude until August 25, 2010. *In the Matter of the Investigation into the Development of the Significantly Excessive Earnings Test Pursuant to Amended Substitute Senate Bill 221 for Electric Utilities*, Case No. 09-786-EL-UNC, Entry on Rehearing (August 25, 2010). Even then as to several of the most critical uncertainties in the statute, the Commission declined to provide any specificity or guidance. *Id.* Finding and Order at 9, 16, 27 (June 30, 2010).

Because the SEET offers virtually no guidance as to its proper application, it is barren of any practical meaning and violates both prongs of the void-for-vagueness doctrine. The statute is unconstitutionally vague, if not on its face, then certainly as applied in this case where the vagueness of the statute is established by the sharply conflicting opinions of the parties' witnesses on several of the most fundamental aspects of how the SEET should be applied to the facts. Because the Commission failed to cure the vagueness of the statute when it had the opportunity to do so in the AEP-Ohio ESP cases and in the SEET investigation case, its only recourse now is to ameliorate the consequences of the statute's constitutional infirmity by following the path laid out by the

Companies' witnesses, which assures that the Companies will not be wrongfully deprived their property.

II. Appropriate 2009 Return On Equity Threshold for the SEET

The Companies retained Dr. Anil K. Makhija to develop a methodology that implements the significantly excessive earnings test.[1] Dr. Makhija presented and explained the methodology that he developed in his Direct Testimony, Companies. Ex. 5, and Rebuttal Testimony, Companies. Ex. 7.

Dr. Makhija's methodology for establishing an appropriate 2009 return on equity threshold for the SEET applicable to CSP and OPCo has two basic components. The first component of his recommended methodology, summarized here and described in greater detail below, involves identifying the group of firms with comparable business and financial risks, the Comparable Risk Peer Group, using well-established metrics. For business risk, he employed unlevered betas. For financial risk, he used the book equity ratio. From the universe of prominent firms, covered in the Value Line *Standard Edition* as of June 1, 2010, he employed a 5 x 5, or 25 cell, methodology to identify the Comparable Risk Peer Group of firms that match CSP and OPCo on unlevered betas and on book equity ratios. Using quintiles to form portfolios, Dr. Makhija divided the publicly traded firms into five (5) different business risk groups (lowest to highest unlevered betas) and five (5) different financial risk groups (lowest to highest book equity ratios). The firms in the same cell as CSP and OPCo, by design, form the

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[1] Dr. Makhija is a Professor of Finance and holds the David A. Rismiller Professorship at the Fisher College of Business at The Ohio State University. Dr. Makhija previously served as the Chairman of the Finance Department at the Fisher College of Business and also as an Associate Dean of the Fisher College. Dr. Makhija's primary research and teaching interests are in the field of corporate finance, and his area of specialization is in applying finance theory to electric utilities. (Companies' Ex. 5, pp.1-3).

Comparable Risk Peer Group. Measuring the earned rates of return on equity (ROEs) of the Comparable Risk Group as normal earnings on average common equity, he obtained that group's mean earned ROE, which is 11.04%. (Cos. Ex. 4, at 35-39 and Table 1 at Panel E) This mean earned ROE is the "baseline" of Dr. Makhija's recommendation for the SEET ROE Threshold.

The second basic component of Dr. Makhija's methodology, also summarized here and described in greater detail below, is to determine the additional amount that, when added to the baseline ROE, establishes the SEET ROE Threshold. In summary, Dr. Makhija recommends defining the ROE Threshold as the mean ROE for the Comparable Risk Peer Group plus 1.96 times the standard deviation of the ROEs for the Comparable Risk Peer Group. It is against this ROE Threshold that the ROEs for CSP and OPCo for 2009 should be compared. Dr. Makhija concludes that the 1.96-standard deviation adder employed to construct the ROE Threshold, which corresponds to a 95% confidence level, is appropriate because (1) it is the established practice to use that confidence level, and (2) because it provides for a reasonably acceptable risk of false positives. Dr. Makhkija confirmed, through several examples, that 1.96 standard deviations, corresponding to a 95% confidence level, is commonly used to determine if the difference between two figures is significant. Consequently, he concluded that the use of a 1.96 standard deviation adder is an appropriate method for determining whether a comparable risk group member's ROE exceeds the group's mean ROE by more than a significant amount. Dr. Makhija determined that the standard deviation of the Comparable Risk Peer Group is 5.85% and, thus, a 1.96 standard deviation adder, corresponding to a 95% confidence level, is 11.47%. (*Id.*)

Dr. Makhija concluded that his methodology is an appropriate approach for establishing the SEET ROE Threshold for several very compelling reasons. First, it best targets comparable firms that match CSP and OPCo in business and financial risk, which is what the statutory language of the SEET requires. Second, it delivers a reliably large sample of comparable risk firms. Third, it is objective, relying upon market-based measures of risk. Fourth, because it is a methodology that may be readily replicated in future proceedings, it is predictable. (*Id.* at 5-6) Dr. Makhija found that for 2009 the mean ROE of the Comparable Risk Peer Group is 11.04% and the standard deviation of the Comparable Risk Peer Group ROEs is 5.85%. Multiplying the 5.85% standard deviation by 1.96 produces an adder of 11.47%. Therefore, he concluded that the 2009 SEET ROE Threshold for CSP and OPCo, which is the sum of the mean ROE and the adder, is 22.51%. (*Id.* at 6).

A. Mean Return On Equity During 2009 Earned By Publicly Traded Companies, Including Utilities, That Face Comparable Business And Financial Risk, With Such Adjustments For Capital Structure As May Be Appropriate.

1. Publicly traded companies, including utilities, that face comparable business and financial risks.

In order to develop a benchmark against which to judge the ROE values of CSP and OPCo, Dr. Makhija developed a statistical method for comparing them to the ROE of a group of publicly traded companies, including public utilities, with similar business and financial risks (Comparable Risk Peer Group), as the SEET requires.

The SEET requires a match of the EDU's financial and business risks across all publicly traded companies. It does not call for the calculation of the difference between the ROE of an EDU and the ROEs of its peer EDUs, followed by an assessment of whether the difference is remarkable in terms of differences in risks. Thus, instead of simply using a traditional comparison with other utilities, the legislation directs that another peer group be defined based on "comparable" risk characteristics, irrespective of the industries from which these peer firms are drawn. Dr. Makhija testified that an approach that does not prejudge what firms, or what types of firms, face comparable risks, is the more comprehensive and, in the end the more reliable approach (Cos. Ex. 5, at 13-14).

Dr. Makhija developed just such a methodology. Using data from the *Value Line Standard Edition* for 2009 available as of June 1, 2010, he first calculated for each publicly traded company in that database the characteristics of interest – business risk and financial risk. Using quintiles to implement a portfolios technique, he then divided firms into 5 different business risk groups (lowest to highest) and 5 different financial risk groups (lowest to highest). From these 25 cells (5 x 5 cells), he chose the cell that has AEP in it. That cell, by design, captures firms that have comparable business and financial risk to AEP. Since SB 221 requires us to focus on the business and financial risks of the subject EDUs, CSP and OPCo, and not the parent, Dr. Makhija checked, and confirmed, that the chosen cell is well-suited for CSP and OPCo, and that AEP's business and financial risks are appropriate starting points for assessing the risks that the two Companies face. (*Id.* at 14-16).

a. Business risk.

Dr. Makhija explained that business risk is the risk arising from day-to-day business operations. For an EDU, the list of sources from which business risk can arise is extensive. Business risk includes uncertainty associated with the revenue stream, the uncertainty associated with operating and maintenance expenses, regulatory risks, fluctuations in weather and demand, and many more. These are the risks that an all-equity firm's business operations face, which are separate from the additional risks that a firm with debt capital faces. (*Id.* at 17).

Dr. Makhija observed that business risks for electric utilities are higher in Ohio than in other states. For example, there is shopping risk since customers have come-and-go-rights, while the EDU retains the provider of last resort status at tariff rates. In another example, the SEET is asymmetric, because there is no provision to recoup past under-recoveries of revenues if the earned rates turn out to be significantly deficient. There is also a requirement in Ohio to have transmission and distribution available for customer generation and distributed generation, a form of asset risk. (Cos. Ex. 5, at 18). Companies witness Hamrock detailed the broad range of business risks faced by CSP and OPCo, many of which result from their ownership of generation assets in a regulatory environment where customers may choose alternative generation service providers. (Companies Ex. 6, at 19-20 and Exhibit JH-2).

To estimate business risk as viewed by the market, Dr. Makhija takes the total risk of the stock and "removes" the financial risk. The total risk of the stock is measured with Capital Asset Pricing Model (CAPM) betas, β_E (using Value Line as the source for the beta coefficients). (Cos. Ex. 5, at 18-20). The financial risk component is removed, allowing the business risk to be measured, by unlevering those Value Line betas. Dr. Makhija used the well-established procedure developed by Hamada to obtain the unlevered betas, β_A (also called asset betas). (*Id.* at 21). Dr. Makhija noted that there are a number of compelling reasons that recommend the use of unlevered betas to measure a firm's business risk:

1. The unlevered beta is derived from the Capital Asset Pricing Model for which William Sharpe received the 1990 Nobel Prize. It captures the risk that shareholders cannot diversify away.

2. The survey of CFOs by John Graham and Campbell R. Harvey ("The theory and practice of corporate finance: Evidence from the field," *Journal of Financial Economics* 61 (2001), 187-243) shows that by far the CAPM is the most widely used model for risk measurement.

3. Betas and the Capital Asset Pricing Model are regularly accepted by public utilities commissions (PUCs) across the United States, including this Commission.

4. Specifically, the use of unlevered betas was accepted by this Commission in Case No. 96-922-TP-UNC. Indeed, Dr. Makhkija uses the same formula for unlevering betas that was employed in that proceeding.

5. The use and calculation of unlevered betas goes back decades to Robert Hamada ("The effect of a firm's capital structure on the systematic risk of common stock", *Journal of Finance* 27, 1972, 435-452).

6. Customer Group Witness Woolridge recommends the use of betas for the measurement of risk.

7. Unlevered betas are a summative measure of total business risk, while other measures such as capital intensity (Revenues to Total Assets) capture only a specific aspect of business risk.

(*Id.* at 20-21.)

Dr. Makhija also addressed the practical issue that betas are only available for firms with traded stock, and concluded that this issue did not affect the appropriateness of using AEP's beta as a basis for measuring the business risk that CSP and OPCo face. He pointed out that the objective is to identify those firms that have comparable unlevered beta risks that match the subject utility, which itself need not be traded. In the case of

Ohio EDUs, he stated that these risks can confidently be imputed from the traded parent firm. Moreover, the SEET does not preclude us from estimating risks of the subsidiary firm in the best way possible. Specifically, the SEET, in § 4928.143(F), only requires that "the commission shall not consider, directly or indirectly, the revenue, expenses, or earnings of any affiliate or parent company." Dr. Makhija also observed that, using AEP's betas for CSPCo and OPCo in the SEET gives us a more conservative application of that test because, according to both known biases regarding estimated betas and actual risk (i.e, betas of less than one understate risk, which applies in the case of AEP's beta during 2009; and betas understate the risk of smaller firms' stock; which applies in the case of CSP and OPCo, each of which is substantially smaller than AEP), AEP's beta understates the risks for CSP and OPCo. (Cos. Ex. 5, at 20 and 21.)

b. Financial risk.

Dr. Makhija explained that financial risk arises from the debt obligations of the firm. Since principal repayments and interest take precedence over payments to common stockholders, debt leverage makes the financial return to common stockholders riskier. The SEET recognizes that different levels of financial risks result from different capital structures, and so it may be appropriate to make adjustments to a firm's capital structure when applying a comparable risk methodology. (*Id.* at 18).

To measure financial risk, Dr. Makhija used the book equity ratio, which is the (Average book value of equity beginning and end of 2009)/(Average of beginning and end of 2009 of total book assets). He chose this ratio because fixed income investors and credit rating agencies look at book equity to determine leverage and financial risk. (*Id.* at 26).

c. Adjustments for capital structure as may be appropriate

Dr. Makhija's procedure takes into account differences in capital structure in two ways. First, in arriving at the unlevered beta, the particular capital structure of each publicly traded firm that is compared to the subject EDU is a factor in that calculation. In particular, he uses the firm's capital structure to unlever and so determine the beta (the desired unlevered beta) had it been an all-equity firm. The second manner in which Dr. Makhija's methodology takes capital structure into account is in the formation of the cells. In dividing the cells into portfolios based on financial risk, he specifically takes the subject EDU's capital structure into account. Dr. Makhija uses the book equity ratio for this purpose. (*Id.* at 25-26.) Accordingly, Dr. Makhija's methodology explicitly addresses, and complies with, the SEET's requirement, when comparing the subject EDU's earned ROE to the earned ROE of the comparable risk firms, to consider "adjustments for capital structure as may be appropriate."

d. Composition of the Comparable Risk Peer Group

The results of Dr. Makhkija's analysis of the Value Line Standard Edition data for 2009, downloaded as of June 1, 2010, which are presented in Table 1 to his Direct Testimony, confirm that the matching methodology he used to construct the Comparable Risk Peer Group identifies truly comparable firms in terms of both financial risk (book equity ratio) and business risk (unlevered beta). Panel C.1. of Table 1 shows that the mean book equity ratio for the Comparable Risk Peer Group for 2009 (0.2954) is well matched with the book equity ratios for CSP (.3070) and OPCo (.3319). With respect to the unlevered betas, the mean for the comparable group, found in Panel C.2, is .3149. While this is higher than the unlevered beta for AEP (.2538), CSP and OPCo are expected to have higher unlevered betas than AEP. Accordingly, Dr. Makhija concludes that the Comparable Risk Peer Group provides a good, likely conservative, match for business risk as well. (Cos. Ex. 5, at 35-38 and Table 1, Panels C and B.)

Panel D of Table 1 to Dr. Mahkija's Direct Testimony, provides the membership of the Comparable Risk Peer Group for 2009. It contains publicly traded utility and non-utility firms, which is consistent with the SEET's directive that the comparable risk group be drawn from "publicly traded companies, including utilities." However, the representation of utilities in the group is extensive, as one might expect. Some 44 out of the 70 comparable group of firms (excluding AEP) or about 63% are utilities (Nat Gas Util, El Util, Oil/Gas Dist, Tele Service, and Cable TV). If regulated industries are counted, the number of firms in the comparable group goes up to 51/70 or about 73%. Nineteen, or about 27%, come from non-regulated firms. In addition to being consistent with the statutory directive to search for comparable risk firms throughout the pool of publicly traded companies, the presence of these non-utility firms in Dr. Makhija'[s Comparable Risk Peer Group also provides evidence that a procedure that eliminates such firms to begin with risks excluding from the SEET viable matching firms of comparable business and financial risk. Had Dr. Makhija started with a pre-set group of industries, he would have hard-wired the procedure to exclude such comparable non-utility firms from being potential candidates for the Comparable Risk Peer Group.

Overall, Dr. Makhija's methodology successfully identifies comparable risk firms. (*Id.*).

2. Confirmatory tests.

Dr. Makhija also tested his recommended methodology, and confirmed its appropriateness and the appropriateness of the SEET ROE Threshold that it produces, by repeating the analysis while incorporating additional criteria for business and financial risks to form the Comparable Risk Peer Group. Specifically, along with unlevered betas, he also employed capital intensity as an additional measure of business risk. Similarly, along with book equity ratios, he also used the Standard & Poor's Long-Term Issuer Credit Rating to measure financial risk. As a result, his findings are not overly reliant on a single business or financial risk metric. Dr. Makhija also conducted other robustness checks to establish the reliability of his methodology, using for example a 10 x 10, or 100 cell, methodology on a larger population of firms (Value Line's full *DATAFILE*) to form the Comparable Risk Peer Group. Dr. Makhija's confirmatory analysis and robustness checks confirmed that his methodology produces consistent, reliable and appropriate results. (Cos. Ex. 5, at 42-44.)

3. Method for calculating the earned return on common equity.

The manner in which Dr. Makhija calculated the earned ROEs of the publicly traded companies considered for inclusion in the Comparable Risk Peer Group is consistent with the Commission's conclusion in its June 30, 2010 Finding and Order in Case No. 09-786-EL-UNC, regarding how earned returns should be calculated. In particular, for the numerator of the earned ROE Dr. Makhija used profit after deduction of all expenses including taxes, minority interests and preferred dividends paid or accumulated, but before any non-recurring, special and extraordinary items. In Value

Line terms that is *Net Income Before Non-recurrings & Extras* minus *Preferred Dividends Paid Accumulated.* For the denominator he employed the average of beginning-of-the-year and end-of-the-year book common equity. The Value Line variable used is *Common Equity Reported,* which "represents the sum of the value of the common stock at par, the surplus of capital received (over par) plus retained earnings." (Cos. Ex. 5, at 11-12.)

4. The Mean ROE of the Comparable Risk Peer Group.

In Panel E of Table 1 to his Direct Testimony, Dr. Makhija provides the distribution of earned rates of return on common equity (ROE) using the primary definition of (*Net Income Before Non-recurrings & Extras for 2009* minus *Preferred Dividends Paid Accumulated for 2009)/(Average of Common Equity Reported for end of 2008 and Common Equity Reported for end of 2009).* The mean ROE for the Comparable Risk Peer Group is 11.04% with a standard deviation of 5.85%. (Cos. Ex. 5, at 38-39 and Table 1, Panel E.)

B. An Earned ROE That Is "Significantly In Excess" Of The Mean ROE Earned By Publicly Traded Companies That Face Comparable Business And Financial Risks.

To assess what degree of deviation from the comparison group's mean ROE can be classified as "significantly excessive," Dr. Makhija drew statistical confidence intervals around the mean ROE of the Comparable Risk Peer Group. He concluded that a confidence interval with a 95 percent level of confidence, which corresponds to an interval of 1.96 standard deviations about the mean and which, when applied to the 5.85% standard deviation of the Comparable Risk Peer Group, translates into an adder of 11.47%, is appropriate. (Cos. Ex. 5, and 28-33).

Dr. Makhija noted that it is natural for the ROEs of OPCo and CSP to differ from the mean ROE for the Comparable Risk Peer Group in any given year. Normal business fluctuations (caused by any number of factors, such as weather for example) imply that such random deviations are expected even if there are no differences in business or financial risks. To determine whether the difference is merely a random deviation or not, he applied standard statistical theory. The mean return for a sample of returns is of course itself a statistical construct. Moreover, the description of the returns to the comparable firms would be quite deficient if it was restricted to merely the mean without a sense of the variation around that mean. Dr. Makhija explained that this is just what the standard deviation is capturing. In other words, the issue at hand, determination of threshold earned rates (Threshold ROE), naturally lends itself to a statistical approach that utilizes the mean ROE of the comparable risk peer group and the standard deviation of the group's ROEs to measure variation of those ROEs about the mean. Accordingly, Dr. Makhija testified that the use of statistical analysis is a reasonable method of looking at this data. (*Id.* at 28.) Notably, the Commission has agreed, confirming in its June 30 Finding and Order, at page 29, in Case No. 09-786-EL-UNC that a statistical approach is an appropriate method for evaluating the earned return of an EDU under the SEET.

Dr. Makhija also pointed out that the use of statistical methods, such as those that he recommends using, does not supplant the role of judgment or reduce the SEET to a mechanical exercise. In that regard, he noted that it is one thing to determine the SEET ROE Threshold rate from the comparable group of firms, and yet quite another matter to determine what is the ROE of the subject utility to be used to compare against the

Threshold ROE or what the appropriate remedies should be in case of significantly excessive earnings.

In addition, the decision regarding the number of standard deviations that should be used to establish the adder to be used in conjunction with the mean ROE is also a matter of informed judgment. Dr. Makhija very carefully examined this issue, and he concluded that for several compelling reasons 1.96 standard deviations, corresponding to a 95% confidence level, is appropriate.

First, he looked at the implications of determining Threshold ROEs at various numbers of standard deviations above the mean for the Comparable Risk Peer Group: He observed that a 1.96 standard deviation adder implies, for a normal distribution[2] and a realistic set of positive (i.e., above the mean) earned ROEs, a chance of 2.5 out of 50, or 5%, of being deemed significantly excessive even though it is the result of normal fluctuation. That is, the likelihood of a false positive is 5%. He noted that 1.64 and 1.28 standard deviation adders imply, for a realistic set of positive earned ROEs, a chance of 5 out of 50 (10%) or 10 out of 50 (20%), respectively, of being falsely deemed significantly excessive. (*Id.* at 29-30) In Dr. Makhija's opinion, ROE Thresholds based on 1.64 or

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[2] Dr. Makhija also acknowledged that the distribution of the Comparable Risk Peer Group has a skewness of 2.44, and a kurtosis 11.61455. That is, the distribution is skewed to the right, and it has fat tails. A distribution without any skewness would have a skewness value of zero, and a normal distribution would have a kurtosis of 3. While a right-skewed fat-tailed distribution is not a normal distribution, Dr. Makhija explained that the question is, what is the implication of such a distribution? He explained that this means that use of the 1.96 standard deviations adder actually provides a higher probability of false positives than what would be implied by a normal distribution. That is, the probability (among positive returns) of a false positive, when using the ROE Threshold that he recommends, is greater than 5%. Accordingly, this makes the Threshold ROE Dr. Makhija recommends using, based on the mean plus 1.96 standard deviations, a more conservative Threshold than would be the case if there were a normal distribution. (Cos. Ex. 5, at 39-40.)

1.28 standard deviations would allow for too high a risk of false positives. He noted that, focusing only on the realistic set of positive earned rates, there are 5 out of 50 chances of naturally falling 1.64 standard deviations above the mean even though the ROEs are not truly excessive earnings. That is, the likelihood of a false positive conclusion – concluding that the earnings are significantly excessive when they really are not – is 10%. With a threshold set at 1.28 standard deviations, he explained that the probability of a mistaken determination of significantly excessive earnings is even greater, 20%. Dr. Makhija concluded that, given the asymmetric nature of the earnings test, a 1.64-standard or a 1.28-standard, instead of the 1.96 standard, would create additional risk for Ohio utilities, which may ultimately adversely affect consumers for whose benefit S. B. 221 has been enacted. (*Id.* at 33.)

Second, instead of focusing on the 5%, 10%, and 20% probabilities of false positives among the realistic set of positive returns, Dr. Makhija examined the implications of 1, 2, or 3 standard deviation cutoffs, above and below the mean, in a normal distribution. Thus, he explained, another way to assess the 1.96-standard deviations (or approximately 2 standard deviations above and below the mean) adder is to compare it with a 1- or 3-standard deviations adder. Dr. Makhija noted that a 1-standard deviation adder would allow a high proportion of ROEs, about one of three instances, to fall outside the 1 standard deviation range above or below the mean. That would categorize too many firms as earning significantly excessive returns, he concluded. He contrasted that result with ROEs that fall beyond 3 standard deviations above or below the mean. These would have a likelihood of only 0.27%, 1 out of 370 instances, which would make ROEs falling beyond that range about the mean a rarity. That is, a very high proportion of firms with high ROEs would not appear to have significantly excessive earnings when using the 3-standard deviations rule. Finally, he considered the middle ground, deviations that are greater than or less than about 2 standard deviations relative to the mean. This occurs about 5% of the time (or 95% level of confidence), or in 1 out of 20 instances, which in his judgment would produce a reasonable frequency of ROEs that are significantly excessive. (*Id.* at 30.)

Third, Dr. Makhija provided several examples which confirm that the 95% confidence level and related 1.96 standard deviations is a commonly applied measure of statistical significance. For example, Dr. Makhkija cited the annual report of the U. S. Department of Education (U. S. DOE) titled *The Condition of Education*, which recommends that persons comparing sample estimates among the data in that report use the 95% confidence level, and corresponding 1.96 standard deviations, to determine whether the difference between two figures is a "real difference" and not "due to chance," i.e., whether the difference is significant (U. S. Department of Education, Institute of Education Sciences. As another example, he noted that the Federal Energy Regulatory Commission's Staff's Final Report on Price Manipulation in Western Markets/Fact-Finding Investigation of Potential Manipulation of Electric and Natural Gas Prices, Docket No. PA02-2-000, at V-13 (March 2003), also provides support for the use of the 95% confidence level and related 1.96 standard deviations to measure significance. Yet another example comes from the United States Department of Justice Programs, Bureau of Justice Statistics (BJS), which puts out an annual report called the National Crime Victimization Survey. The publication describing the survey methodology explains that to determine whether the difference between two rates in the survey is statistically significant, the BJS uses a "z" score of 1.96, which "indicates that the difference is significant at the 95% confidence level (or greater)[.]" Finally, Dr. Makhija pointed out that a widely followed organization that has been conducting polls for over 75 years, Gallup, also uses a 95% confidence level. (*Id.* at 31-33.)

In sum, Dr. Makhija uses the 1.96-standard because it is the mostly commonly applied standard, and because it offers, in his opinion, a reasonably acceptable risk of false positives. (*Id.* at 30.)

C. Customer Group and Staff Recommendations.

Customer Group witness Woolridge and Staff witness Cahaan make various recommendations regarding what they believe would be appropriate methodologies for establishing a SEET ROE Threshold. They have also offered several criticisms of the methodology that Dr. Makhija presented on behalf of the Companies. (Jt. Int. Ex. 1; and Staff Ex. 1) The main issues that their recommendations and criticisms raise center around the identification of comparable firms and the setting of the threshold for significantly excessive earnings.

Dr. Makhija reviewed the methodologies proposed by Dr. Woolridge, and concluded that his selection of comparable firms does not conform with the SEET. Dr. Makhija also addressed the concerns raised by Mr. Cahaan regarding the use of a statistical approach for determining the threshold for significantly excessive earnings and confirmed that a statistical approach is appropriate.

1. Woolridge

a. Comparable risk group

Customer Group witness Woolridge (a) first identifies a so-called "proxy group" of electric utility companies; (b) then, estimates the business and financial risks of this "proxy group" of electric utilities to establish a range of values for business risk and financial risk; and (c) finally, forms the comparable risk group by identifying all firms (from the universe of firms available in the Value Line Investment Analyzer) that have business risk and financial risk within the ranges for the "proxy group." (Jt. Int. Ex. 1.)

Dr. Makhija explained that there are several problems with this procedure. (Cos. Ex. 7, at 3-6) First, the procedure limits comparable firms to only those that have the characteristics of other electric utilities. This is contrary to the language and spirit of the SEET, which requires that the matching firms include non-utility firms. Not surprisingly, with Dr. Woolridge's restrictive "proxy group" of electric utilities as the starting point, the procedure is hard-wired to produce a sample of comparable firms that is overwhelmingly made up of regulated firms. As a result, there are only 2 non-utility firms out of the 45 that form his comparable risk group (96%) although he searches many thousands of firms in the full Value Line Investment Analyzer database. The problem is that Dr. Woolridge prejudged the types of firms that should be of comparable risk for purposes of the SEET to include only a select group of electric utilities. (Cos. Ex. 7, at 3-4.)

The limitations of the Woolridge procedure become apparent by a review of his list of "proxy group" firms identified in Exhibit JRW-1 to his Direct Testimony (Jt. Int.

Ex. 2, at 6) and their characteristics that he provides in his Exhibit JRW 2 (*Id.* at 8). Dr. Woolridge's method for selecting his "proxy group" would lead to the same list of proxy firms for each EDU in Ohio. (Cos. Ex. 7, at 4; Tr. 334-335) Indeed, it does not appear that any electric utility would ever receive a different proxy group than any other electric utility, under Dr. Woolridge's approach; and, thus, it does not appear that any electric utility would ever receive a different comparable risk group than any other electric utility under Dr. Woolridge's approach. In fact, the particulars – business and risk characteristics – of the subject electric distribution utility never even enter Dr. Woolridge's procedure in the determination of the final comparable group of firms. Accordingly, significant risk characteristics of the subject EDU, such as whether it owns generation assets and its customers simultaneously have retail choice, risks that CSP faces, are not relevant to Dr. Woolridge's approach.

The matching problem is apparent from Dr. Woolridge's screens that he uses to find matching firms. For the search for his Comparable Public Companies, Dr. Woolridge uses a range of beta values based on its variation among his Electric Proxy Group firms. This range of betas is 0.60 to 0.75. In 2009, AEP had a beta of 0.70 according to Dr. Woolridge (Jt. Int. Ex. 1, at Exhibit JRW-3). Dr. Makhija noted that AEP's beta is quite close to the maximum of the range for Dr. Woolridge's Electric Proxy Group. Dr. Makhija explained that this is a problem because we expect CSP's beta to be actually higher than that of AEP because it is known that smaller firms have higher betas, other things being similar. According to Dr. Makhija, this puts CSP outside the range used to search for Comparable Public Companies. In short, Dr. Woolridge searched for the wrong set of comparable firms. (Cos. Ex. 7, at 5-6.) Subjectively prejudging which types of firms match the risks faced by CSP amounts to a "black box" selection procedure.

Dr Woolridge did not have to form his proxy group without regard to the business and financial risks of CSP or OPCo. As Dr. Makhija points out, Dr. Woolridge used a range of capital intensity (an important component of business risk) and a range of common equity ratios (a measure of financial risk), both derived from his proxy group of electric utilities, to screen the Value Line data base for comparable risk firms. CSP and OPCo have their own specific capital intensity and common equity ratios (as does their parent, AEP) neither of which even enter Dr. Woolridge's procedure at the proxy group composition step, (Cos. Ex. 7., at 5; Tr. II at 337-338), let alone at the step where he screens the universe of publicly traded companies for comparable risk firms.[3]

Where Dr. Woolridge went wrong with regard to the composition of the comparable risk group of publicly traded companies is that he prejudged the risk characteristics of the comparable group by choosing the "proxy group" without regard to any business or financial risk measures of the subject utility. Though the SEET does not restrict the comparable set of firms to a specific industry, Dr. Woolridge actively sought to do so.

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[3] Besides being invoked too late to screen for the right matches of comparable risk public companies, Dr. Woolridge's formulations of the business risk measures, where he does use them, are not appropriate. Though he refers to "Asset Turnover" for capital intensity, Dr. Woolridge actually uses Revenues/Net Fixed Assets. The proper comprehensive measure would entail Total Assets and should be Revenues/Total Assets. Based on his use of year-end betas, it would also appear that he uses the year-end values for Net Fixed Assets, while the more appropriate measure that takes into account changes during the year would be the *average* Net Fixed Assets over 2009. The other business risk measure used by Dr. Woolridge is the Value Line beta, but it is a levered beta, and so commingles business and financial risk. (Cos. Ex. 5, at 6.)

Dr. Woolridge also erred in the manner in which he took into account capital structure differences among the comparable risk firms and the subject EDU. Dr. Makhija noted that, in the case of the SEET, what we are interested in is, what rate was earned by common equity holders if the comparable firms had the same capital structure as the subject utility? So, he pointed out, the analyst must begin with the total returns for the comparable firms to all capital, including short-term debt. We cannot assume, as Dr. Woolridge has done, that there is no net short-term debt. Next, after finding the total returns for the comparable firms, we need to determine earned rates to common by re-leveraging at the debt level of the subject utility. Again, short-term debt and its interest costs should be incorporated, but is ignored by Dr. Woolridge. In essence, Dr. Woolridge is taking a familiar approach from the rate-making type of exercise for estimating a forward looking cost of equity and applying it in a situation where it does not fit. (Cos. Ex. 7, at 6-7.)

The Commission should reject Dr. Wooridge's proposed group of comparable risk publicly traded companies. Dr. Makhija's method for selecting the comparable risk group, and the group that he has identified, should be used.

b. ROE of the comparable risk group

Once he has identified his group of Comparable Public Companies, Dr. Woolridge contends that the proper measure of that group's ROE is the median ROE, which he says is 9.58%. By proposing use of the median, he abandons his prior application of the SEET in the 2008 ESP proceedings in several ways, including his earlier use of the mean ROE. (Tr. II at 344-342.) He now argues that the SEET requires the determination of "the return," in the singular, and that the median is better suited for that purpose.

Dr. Wooridge's switch to the median from the mean is flawed. The same sentence in Section 4928.143(F) that contains the words, "the return", goes on to refer to what was earned by "publicly traded companies," in the plural. Accordingly, the task before us is to capture the performance of a group of firms with comparable business and financial risks. Dr. Makhija explained that the median is inadequate for this purpose since it does not respond to the variation in ROEs among the sample group of comparable firms. Besides its contribution to the mean ROE of the comparable group, the deviation from that mean of each comparable firm also contains information about all of the comparable firms' ROEs. Thus, while the mean is important, so is the standard deviation of the ROEs of the firms in the comparable group. For example, two alternative comparable groups might have the same mean ROE, but one group could have its members' ROEs tightly distributed close to the mean while the other might have ROEs widely dispersed about the mean. The mean and standard deviation help provide the complete picture regarding the distribution of the comparable risk firms' ROEs. (Cos. Ex. 7, at 7-9.) The Commission should reject Dr. Woolridge's recommendation to use the median statistic. Rather, the Commission should use the mean statistic to measure the baseline ROE of the comparable risk group of publicly traded companies.

c. **SEET ROE Threshold**

To the ROE of the comparable risk group Dr. Woolridge proposes adding 200 to 400 basis points to arrive at the SEET ROE Threshold. The adder that Dr. Woolridge has selected is the result of an arbitrary calculation that has no connection to the comparable risk group to whose mean (or median) ROE is added. If a subject firm is risky, we would expect greater variation in the ROEs of its comparable firms. A fixed adder that applies to one and all does not reflect the unique business and financial risks of a subject utility, nor does it follow the "case-by-case basis" directive in the Finding and Order of the Commission. (Cos. Ex. 7, at 9-10.) Dr. Woolridge conceded that his proposed adder of 200 to 400 basis points is not based on anything specific about CSP. (Tr. II at 353-54).

Besides being arbitrary, using Dr. Woolridge's adder an unreasonably high number of firms will fail the SEET. With the 200 basis points adder (and using his revised CSP benchmark ROE of 9.58%), his Threshold ROE is 11.58%. That is, almost every fourth firm among his group of Comparable Public Companies earned significantly excessive earnings (Jt. Int. Ex. 1, at Exhibit JRW-4), according to Dr. Woolridge. (Cos. Ex. 7, at 10.) If applied symmetrically, above and below the median, approximately half the firms in his comparable risk sample had ROEs that were significantly excessive (11 ROEs) or deficient (10 ROEs), when compared to his 9.58% median ROE, at his proposed 200 basis points adder level. (Jt. Int. Ex. 1, at Ex. JRW-4.) Nearly 18% (nearly one in six) of his comparable risk group had significantly excessive (4 ROEs) or deficient (4 ROEs) ROEs at the 400 basis points end of his proposed range. (*Id.*) A SEET ROE Threshold based on Dr. Woolridge's proposed adder would clearly result in excessive failure rates with dire consequences for attracting capital to Ohio's utilities.

Dr. Woolridge's proposal of an adder of 200 to 400 basis points should be rejected. Instead, Dr. Makhija's recommendation or an adder of 1.96 standard deviations above the mean ROE of the Comparable Risk Peer Group should be adopted.

2. Cahaan

Mr. Cahaan recommends the use of a benchmark ROE for the comparable risk group of 10.7%, which he proposes to increase by an adder equal to 50% of that benchmark ROE of 5.35%, in order to arrive at a SEET ROE Threshold of 16.05% that, in his opinion, reflects the level at which the EDU's ROE would become significantly excessive.

a. ROE of the comparable risk groups sampled

Mr. Cahaan did not actually identify a particular group of comparable risk firms in order to develop his benchmark ROE recommendation. Instead, he examined the analyses that Dr. Makhija and Dr. Woolridge conducted for this proceeding, and he applied the analysis sponsored by Michael J. Vilbert in the FirstEnergy SEET proceeding, Case No. 10-1265-EL-UNC, after adapting that analysis to CSP's situation. In addition, he examined the ROEs of groups of companies contained in two published and market-traded indices relating to utilities and energy. He noted that the mean ROE of the Woolridge approach is 9.58%, the mean ROE of Dr. Makhija's approach is 11.04%, and the mean ROE of the Vilbert approach (applied to CSP) is 11.53%. He also observed that the benchmark ROEs for the two indices for 2009 were 11.39% (for the Utilities Select/S&P 500 Index) and 11.15% (for the Dow Jones Utilities Sector Index). After reviewing the distribution of the three comparable risk group mean ROEs along with the two benchmark ROEs, Mr. Cahaan concluded that a range of 10% to 11% is reasonable, with a bit more evidence arguing for the high side of this range, and so arrived at his recommendation to use 10.7% as the benchmark ROE for purposes of this proceeding. (*Id.* at 12-13.) Although he disavows using a precise mathematical process to arrive at

10.7%, it is noteworthy that the arithmetic average of the three mean ROEs ((9.58% + 11.04% + 11.53%) ÷ 3) would result in the same 10.7% value.

Mr. Cahaan apparently accepts the use of the mean ROE derived from a comparable risk group to develop the "benchmark" ROE for the SEET Threshold. The Companies agree that the mean statistic is appropriate for determining the ROE of the comparable risk firms. For the reasons provided above, however, Dr. Woolridge's methodology does not produce a group of firms whose business and financial risks match those that CSP or OPCo faces. Consequently, the Companies contend that Dr. Woolridge's results cannot be an appropriate element of any SEET ROE Threshold. Rather, the Companies maintain that Dr. Makhija's approach, and his recommendation of 11.04% as the mean ROE of the comparable risk group should be adopted as the baseline (or "benchmark") ROE for the SEET Threshold.

b. SEET ROE Threshold

It is also noteworthy that, while Mr. Cahaan is reluctant (indeed opposes) using a statistical approach to develop the margin to be added to the baseline ROE for the comparable risk group, he does rely upon the mean ROE of that group to establish the baseline ROE for the SEET Threshold. First of all, as mentioned above, the Commission has already determined in its June 30 Finding and Order in Case No. 09-786-EL-UNC that statistical methods may be used as part of the evaluation of whether the EDU's earned ROE is significantly excessive. Second, as Dr. Makhija has pointed out, the mean return for a sample of returns is, of course, itself a statistical construct. Moreover, he testified, the description of the returns to the comparable firms would be quite deficient if it was restricted to merely the mean without a sense of the variation around that mean.

This is just what the standard deviation captures. The confidence levels merely set the probabilities of observing these returns. In other words, the issue at hand, determination of threshold earned rates, naturally lends itself to a statistical approach. (Cos. Ex. 5, at 28.)

Third, it is also notable that Mr. Cahaan's 50% adder, which amounts to 5.35% based on his recommendation of a 10.7% baseline ROE, is close to one standard deviation (which is 5.85% using Dr. Makhija's comparable risk group).[4] (Tr. II at 594-95.) Consequently, one way to look at Mr. Cahaan's position is that his concern is not so much with the use of a statistical approach but, rather, with the adoption of an adder mechanism that produces, or might produce, an adder that is "too large." Viewed in that light, the discussion really turns on how the Commission should exercise its judgment regarding the matter.

Respectfully, the Companies believe that the 50% adder is too low. This can be seen by considering the frequency with which such an adder would characterize firms in the comparable risk group as having significantly excessive ROEs during 2009. As Dr. Makhija explained, in a normal distribution, a 1-standard deviation adder would allow a high proportion of ROEs, about one of three instances, to fall outside the 1 standard deviation range above or below the mean. (Companies Ex. 5, p. 30.) The adder that Mr. Cahaan has proposed, would equate to less than one standard deviation, so in the normal course it would actually result in even more than one out of three ROEs falling outside 50% above or below the mean. In addition, to the extent that the distribution of

[4] For example, if applied to Dr. Makhija's 11.04% mean ROE, Mr. Cahaan's approach would yield a 5.52% adder, very close to the one standard deviation (5.85%) that would result from using Dr. Makhija's comparable risk group.

comparable risk companies is somewhat right-skewed and fat-tailed, as is the case with the comparable risk group that Dr. Makhija identified, an even greater proportion of firms with ROEs at or above the mean would fall outside the threshold ROE (Cos. Ex. 5, at 39-40.) Accordingly, an adder of 50% simply would categorize too many firms as earning significantly excessive returns.

Mr. Cahaan attempts to support his concern regarding Dr. Makhija's recommendation of an adder of 1.96 standard deviations through an examination of what the adder would look like if it were used to establish a significantly deficient earnings threshold. Mr. Cahaan notes that if the adder were used in that fashion, and Dr. Makhija's 1.96 standard deviations were adopted, the EDU's earned ROE would be significantly deficient at or below negative .43%. Mr. Cahaan surmises that utility managers who sought to excuse such a financial performance as not deficient, when questioned by analysts or their stockholders about it, would not be credible. (Staff Ex. 1, at 13-14.) With all due respect, the significantly deficient "sanity check" that Mr. Cahaan applies uses the wrong perspective and, as a result, misses the correct point. In particular, his focus on whether utility management would accept negative ROEs (of course they would not) incorrectly relies upon the utility's management perspective. The assessment of what is significantly deficient should come from the customers' point of view, just as the assessment of what is significantly excessive has its basis in the customers' perspective.

Accordingly, the question that Mr. Cahaan should have used to test the proposed adder is, assuming a symmetric earnings test that also examines whether the EDU's earned ROE is significantly deficient, at what earned ROE level should customers be required to pay additional amounts to make up for a prior period's "significantly deficient" earnings? Note, in this regard, that if the earnings test were symmetric, Dr. Woolridge's position would be that when earnings went below 5.55% - 7.55% (9.55% minus 400 - 200 basis points), customers would have to pay additional amounts to restore earnings to the 5.55%-7.55 level; and Mr. Cahaan's position would be that when earnings declined below 6.35% (10.7% minus 5.35%), customers would have to pay additional amounts to restore earnings to the 5.35% level. If this "sanity check" were applied to either of Dr. Woolridge's or Mr. Cahaan's methodology, it would provide the following consequences for 2009. The customers of at least two of the FirstEnergy EDUs (and the customers of all three of them if Dr. Woolridge's approach and his 200 basis point adder were used) would have faced the prospect of owing their EDUs additional amounts for 2009, because their EDUs' ROEs (3.8% for The Toledo Edison Company; 5.2% for The Cleveland Electric Illuminating Company; and 6.2% for Ohio Edison Company (Jt. Int. Ex. 2, at 18).) would have been below the "sufficiently deficient" ROE thresholds that the methodologies of both Dr. Woolridge and Mr. Cahaan would have produced. (Tr. II at 367-368.)

When Mr. Cahaan's hypothetical is analyzed from the correct – customer – perspective, it becomes clear that the adder that Mr. Cahaan has recommended, as well as the adders that Dr. Wooridge has recommended, are too low, and the appropriateness of Dr. Makhija's proposed adder is further supported.

Mr Cahaan also is concerned that Dr. Makhija's methodology does not yield a "stable" set of comparable firms. As Dr. Makhija pointed out, the fact that his comparable risk group is not static over time may very well be a strength of his methodology, because it demonstrates that the methodology is responsive to changes in the risks that the subject EDU faces. Dr. Makhija noted that, in light of the significant reduction in AEP's beta from 2007 to 2009, it is logical that there would be differences in the composition of the comparable risk group over the same time period. (Cos. Ex. 7, at 17.)

Mr. Cahaan's other concern with Dr. Makhija's approach is that it is the risks faced by the firm, not the firm's investors, that the SEET addresses. That observation, if pertinent, would only make Dr. Makhija's approach more conservative than what the SEET requires, because the firm faces diversifiable and non-diversifiable risks, while the investor can avoid diversifiable risks. (Cos. Ex, 7, at 18.) In any event, Mr. Cahaan's criticism is misguided because the SEET focuses on "earned return on common equity", the investor perspective, and not on the return on assets, which represents the firm's perspective.

D. Conclusion Regarding Appropriate 2009 SEET ROE Threshold

The Commission should find that for 2009 the mean ROE of the Comparable Risk Peer Group is 11.04% and the standard deviation of the Comparable Risk Peer Group ROEs is 5.85%. The Commission should further find that the appropriate adder to be used to establish the level at which the Companies earned ROE for 2009 may become significantly excessive is calculated by increasing the mean ROE by 1.96 standard deviations, which produces an adder of 11.47%, and that the Companies' 2009 SEET ROE Threshold, which is the sum of the mean ROE and the adder, is 22.51%.

III. CSP's and OPCo's Earned Return on Equity for 2009

Companies witness Mitchell addressed the appropriate method for calculating each Company's earned return on common equity (ROE) including deductions for Off-System Sales (OSS). Mr. Mitchell also performed the calculation of the earned ROE for both CSP and OPCo for the year ended December 31, 2009. He then provided his calculations of the Companies' earned ROEs for 2009 to Mr. Hamrock, (Cos. Ex. 4. at 3-5 and Ex TEM-1), who then used the earned ROEs to make the comparison with the 2009 SEET ROE Threshold.

Mr. Mitchell performed the calculation of the ROEs in two steps. First, he calculated the respective 2009 ROE for both CPS and OPCo, using the amounts for net earnings available to common shareholders compared to the beginning and ending average equity for the year ended December 31, 2009. (*Id.* at Exhibit TEM-1.) The Commission determined that use of the beginning and ending average equity is appropriate in its August 25 Entry on Rehearing in Case No. 09-786-EL-UNC, at page 6, and it is also consistent with the calculation of the average equity that Dr. Makhija used in connection with his development of the Comparable Risk Peer Group. For 2009, there was no minority interest, nor any non-recurring special or extraordinary items for either CSP or OPCo. (Cos. Ex. 4 at 4-5.) In the second step of his calculation, Mr. Mitchell implemented the Companies' recommendation, supported by Companies witness Hamrock, to adjust the Companies' earned ROEs by subtracting the OSS net margins (after federal and state income tax) from the net earnings available to common shareholders. (*Id.* at 5.)

A. Adjustment to exclude Off-System Sales margins

There are two primary reasons that support adjusting the Companies' earned ROEs by subtracting OSS net margins. First, Section 4928.143(F), Revised Code, specifically provides that only earnings resulting from adjustments included in the EDU's ESP are subject to the SEET. Off-system-sales margins, which result from wholesale, not retail, transactions, are not the result of a rate adjustment included in CSP's or OPCo's ESP. They result from wholesale transactions approved by the Federal Energy Regulatory Commission (FERC). Second, as set forth in more detail below, 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 being subject to refund under the SEET statute. AEP Ohio believes that the most efficient approach to complying with Section 4928.143(F), Revised Code, and avoiding conflict with the FERC's jurisdiction is to remove earnings resulting from OSS margins from the calculation of CSP's and OPCo's earned ROE.

1. Companies witness Mitchell properly calculated CSP's 2009 earnings excluding OSS margins to be 18.31%

As referenced above, at the request of Companies witness Hamrock, Mr. Mitchell calculated CSP's earned return on equity for 2009, starting with the per books return of 20.84% excluding earnings associated with off-system sales (OSS) to obtain an adjusted return of 18.31%. (Cos. Ex. 4 at 5, Ex. TEM-1.) Mr. Mitchell's calculation of earnings with and without OSS margins is consistent with the Commission's directive on page 9 of the June 30 Finding and Order, wherein the Commission explicitly determined that it would consider OSS earnings adjustments in individual utility cases and directed utilities to quantify the effect of excluding OSS from the SEET calculation.

Staff witness Cahaan takes issue with Mr. Mitchell's OSS earnings adjustment, arguing that the denominator should also be adjusted. (Staff Ex. 1 at 20.) Specifically, Mr. Cahaan allocated away 13.9% of CSP's net production plant based on sales revenues. (*Id.*) The result of Mr. Cahaan's approach was to restate CSP's adjusted earnings without OSS to be 19.73%. CSP maintains that Mr. Mitchell's calculation of 18.31% correctly reflects CSP's earnings without OSS margins. As Mr. Mitchell explained on the stand during examination, he used the same equity adjustment method that is described in the June 30 Finding and Order and August 25 Entry on Rehearing when he excluded the OSS earnings:

> As I indicated on page 5 of my testimony, I applied the Commission's method of simply using the beginning and the average of the equity without any adjustment for any deductions which is consistent with their orders in June and August of 2010. I'd just like to reiterate that the June order in particular talked about that the numerator should have deductions for special nonrecurring or extraordinary items, but there was no comparable language with respect to the denominator, so as I indicated on page 5, I applied the Commission's method.

(Tr. I at 78.) In other words, Mr. Cahaan's criticism of Mr. Mitchell's approach is essentially a criticism of the Commission's endorsed method for making equity adjustments.

The Commission's June 30 Finding and Order provided (at 18) that the earned return should exclude nonrecurring, special and extraordinary items. Specifically, the Commission ordered that such items should be excluded from the Company's earnings. There was no provision for a "denominator adjustment" and Mr. Cahaan's proposal to assume away a portion of CSP's production plant varies from the method outlined in the June 30 Finding and Order and it should not be adopted. CSP's 2009 earnings level without OSS margins is 18.31%.

2. The SEET statute should not be interpreted or applied to encompass the claw back of OSS margins, as doing so would be unlawful

OSS margins result from wholesale, not retail, transactions whose rates are authorized by the FERC. Ordering earnings that result from FERC jurisdictional wholesale sales to be returned to retail customers clearly would be unlawful. It also would be unlawful to include earnings resulting from wholesale sales in the SEET to justify refunds to retail customers. 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 FERC. *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).

While the typical federal preemption case under the Federal Power Act and the Supremacy Clause arises in the context of the filed rate doctrine and states' attempts to disallow the recovery of the costs of FERC-approved wholesale power sales in retail rates, the preemptive effect of FERC's exclusive jurisdiction over wholesale power sales is broader than just that one application. Because FERC as a matter of federal law completely occupies the field of wholesale power sales, "the test of pre-emption is whether 'the matter on which the State asserts the right to act is in any way regulated by the Federal Act.'" *PG&E v. Energy Resources Comm'n*, 461 U.S. at 213. Cf. *Northern Natural Gas Co. v. State Corp. Comm'n*, 372 U.S. 84, 90-91 (1963) (rejecting state's argument that its orders were not preempted because they did not actually invade the regulatory jurisdiction of the Federal Power Commission because the orders did not involve the price of gas).

Just as the State may not trap FERC-approved wholesale power 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. A state determination that wholesale earnings are excessive is no different than a state determination that wholesale rates are unreasonable. And, diverting wholesale power revenue to retail customers after-the-fact has the same practical effect as disallowing wholesale power costs in the first instance. Both actions would equally interfere with FERC exclusive right to regulate the wholesale power market – earnings as well as rates.

Moreover even if the Commission stops short of actually seizing wholesale earnings and putting them in the pool of earnings to be refunded to customers, its action still may be unlawful. Including earnings from wholesale power sales in calculating the Companies' ROE also invades the exclusive authority of the FERC, albeit it may be a lesser included offense. FERC has "exclusive authority to regulate the transmission and sale at wholesale of electric energy in interstate commerce." *New England Power Co. v. New Hampshire*, 455 U.S. 331, 340 (1982). There is a "bright line" between wholesale regulation and retail regulation. *Mississippi Power & Light Co.*, 487 U.S. at 374, which means the State may not reach across that line and use wholesale earnings to justify retail refunds. To do so, in effect, penalizes or disadvantages the Companies for achieving earnings that were lawfully achieved as a matter of federal law.

The theory that the Commission must include wholesale earnings in calculating the ROE in order to have an "apples-to-apples" comparison with the benchmark companies is no defense to its conduct. The purported justification ignores the fact that the Commission has jurisdiction only over the Companies' retail sales. For purposes of the SEET, the only relevant earnings – and the only earnings that may properly be at issue – are those derived from sales within the Commission's jurisdiction. Moreover, the "apples-to-apples" comparison is achieved through the establishment of the appropriate comparable group and measuring the mean return of that group and establishing the ROE threshold. Thus, considering only the jurisdictional earnings in comparing the EDUs earned return to the comparable group is appropriate given that the *raison d'etre* of the SEET statute is to determine whether the rate adjustments of the ESP have resulted in significantly excessive earnings.

Any orders by the Commission that claw back OSS margins would conflict with the Federal Power Act and Congress' power under the Supremacy Clause. Moreover, because the State's obvious purpose in enacting the SEET is to protect state consumers from retail rate increases, any such orders 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); *Middle South Energy v. Pub. Serv. Comm'n*, 772 F.2d 404, 416 (8th Cir. 1985)("[W]here simple economic protectionism is effected by state legislation, a virtual per se rule of invalidity has been erected."). If the Companies' OSS have produced significantly excessive earnings, those earnings should be refunded, if at all and at FERC's direction, to the wholesale customers who bought that power and not appropriated by Ohio for the exclusive benefit, directly or indirectly, of Ohio retail customers.

3. CSP's Electric Security Plan does not include a rate adjustment for OSS margins and it would be unfair and bad regulatory policy to subject OSS margins to being clawed back under the SEET statute

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. 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. AEP Ohio believes that the most appropriate and 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. Rationalizing the inclusion of OSS margins in the SEET by characterizing the generating assets that produce the margins as "customer-funded assets" – as Customer Group witness Kollen does – also misses the mark. (Jt. Int. Ex. 2 at 22) Customers pay rates for retail service, not for the assets that produce those services, let alone for assets that produce wholesale services. See e.g., Case No. 88-102-EL-EFC, Opinion and Order (October 28,1988) (The inclusion of an equipment rental component in the cost of coal does not confer the benefits or the risks of ownership of the equipment on those who pay EEC rates which include cost of coal); Entry on Rehearing (December 20, 1988) (ratepayers purchased service and were not purchasing an ownership interest in the equipment). Consequently, customers have no entitlement to share in OSS margins produced by CSP. More to the point of the application of SEET to CSP's ESP, the Commission already considered and rejected the proposal of reflecting OSS margins as part of CSP's fuel adjustment clause. (*ESP Case*, Opinion and Order at 17.)

By contrast, Mr. Kollen acknowledged that in those jurisdictions that involve OSS margin sharing, retail rates go up when OSS margins are down (all else being held constant). (Tr. II at 404.) Yet, he understood that CSP's ESP did not contain a rate adjustment relating to OSS margins and indicated that he did not include OSS earnings in his refund cap – adding that he thought it would be inappropriate to do so. (Tr. II at 405.) Because the only adjustments authorized by the Commission for inclusion in CSP's ESP were those that were based on actual prudently-incurred costs, basing a refund on OSS margins would have the effect of disallowing cost recovery which had been authorized by the Commission. Such a result is unsupported in applicable law and basic fairness. It would be unjust and unreasonable to conclude now that, while the ESP rates are not to be adjusted to reflect OSS margins, the SEET under that ESP will encompass OSS profits and subject them to being refunded during the ESP.

The key factual premise of Mr. Kollen's argument is also inaccurate, because ratepayers are not necessarily paying for the carrying costs associated with CSP's power plants under SB 221, as reflected by the Commission's denial in the *ESP Case* of any revenue requirement allowance for CSP's Darby and Waterford plants that have historically never been included in rate base. (*ESP Order*, Case Nos. 08-917-EL-SSO and 08-918-EL-SSO, July 23, 2009 Entry on Rehearing, at 35-36.) Indeed, there is no generation rate base under SB 221 or CSP's ESP.

Moreover, contrary to the assumption made by the Customer Parties, the substantial efforts of the American Electric Power Service Corporation (*i.e.*, the corporation that serves AEP Ohio and other AEP affiliates) to create OSS margins goes well beyond the traditional notion of selling excess energy to neighboring utilities, and a significant portion of the OSS margins are not even tied to physical sales of energy from power plants owned by AEP operating companies such as AEP Ohio. As Companies witness Hamrock testified, surplus energy sales only support a portion of the OSS margins achieved by CSP during 2009. (Cos. Ex. 6 at 6.) More specifically, Companies witness Mitchell explained that only 40% of CSP's 2009 OSS margins were related to physical sales (*i.e.*, sales of energy from CSP generation plants). (Tr. I at 75.)

Finally in this regard, Customer Group witness Kollen offered the existence of OSS margin sharing in other AEP-East jurisdictions as evidence that AEP Ohio's position in this case is invalid. (Jt. Int. Ex. 2 at 24.) The OSS sharing examples cited in Mr. Kollen's testimony for AEP-East operating companies all involved sharing between the company and its ratepayers – so that only a portion of the OSS Margins are reflected in retail rates. (Tr. II at 403.) Mr. Kollen admitted that he does not know whether the OSS sharing in those other jurisdictions is based on statute or whether they are subject to an earnings test. (Tr. II at 404.) Companies witness Hamrock pointed out in his rebuttal testimony that retail rates established for the other AEP-East operating companies were based on varying regulatory requirements that are not applicable to Ohio; sharing in those jurisdictions does not support the idea of including the full measure of OSS margins achieved by CSP in 2009 to being refunded under the SEET. (Cos. Ex. 6 at 5-6.) Further, as indicated by Mr. Hamrock in his rebuttal, imputing test year/audit period OSS margins when prospectively setting rates using a traditional rate base/rate of return methodology is qualitatively different than inclusion of OSS margins when implementing the prospective SEET test under the ESP – especially when the Commission already determined that OSS margins should not be reflected as a rate adjustment in that ESP. (*Id.* at 6.) Thus, Mr. Kollen's reliance upon OSS margin sharing in other jurisdictions is misplaced.

B. Other non-jurisdictional earnings

While there are other non-jurisdictional activities and gains or losses that impact CSP's and OPCo's earnings, the Companies did not attempt to fully jurisdictionalize the 2009 earnings for purposes of this discussion but reserves the right to do so if necessary. (Cos. Ex. 6 at 7.) As Companies witness Hamrock confirmed that there are some non-OSS wholesale transactions exist. (Tr. I at 136-137.) But this is an issue that is not material for this 2009 proceeding but which needs to be preserved for future SEET proceedings.

During cross examination, the parties raised other FERC-approved, non-jurisdictional agreements such as the AEP Pool agreement for generation or the AEP transmission services and queried why AEP Ohio did not make any earnings adjustments relating to those matters. As Mr. Hamrock noted, the AEP Pool inherently serves retail customers (Tr. I at 148.) Mr. Mitchell also noted that Pool transactions are done at cost so profit impact is minimal (Tr. I at 73.) Similarly, transmission rates are based on wholesale services that support the provision of retail service and are also passed through to retail customers through rates. By contrast, OSS margins do produce material earnings but there is no ESP rate adjustment for OSS margins and they have no relationship to the retail jurisdiction or SEET (Tr. II at 267.) In any case, the Companies submit that other non-jurisdictional earnings might be an issue for future SEET cases but is not an issue in this case (it does need to be preserved for those future cases).

IV. Initial Comparison of CSP's and OPCo's 2009 Adjusted Return to ROE Threshold for SEET

As discussed below, using the Companies' testimony for establishing the ROE threshold and excluding OSS margins from earnings used for SEET produces the following results:

Quantitative SEET Comparison for 2009	**Safe Harbor ROE Test**	**Benchmark ROE Test**
ROE Threshold	13.04%	22.51%
CSP Earned ROE	18.31% without OSS margins (20.84% per books)	18.31% (20.84% per books)
OPCo Earned ROE	9.42% without OSS margins (10.81% per books)	9.42% (10.81% per books)
Test Results	<u>OPCo Passes</u> (both per books and adjusted	<u>OPCo and CSP Pass</u> (both per books and adjusted)

A. "Safe harbor" applies to OPCo's 2009 earnings

The Commission's June 30 Finding and Order established a "safe harbor" of 200 basis points above the mean of the comparable group, below which the EDU will be found not to have significantly excessive earnings. While earning a return on equity that falls under the safe harbor ensures that no significantly excessive earnings exist, merely earning a return above the safe harbor does not in any way establish that significantly excessive earnings exist. Companies witness Dr. Makhija's benchmark ROE for 2009 is 11.04% (implying a safe harbor of 13.04%) and Customer Group witness Dr. Woolridge's recommendation is 9.58% (implying a safe harbor of 11.58%), while Staff witness Cahaan's recommendation is 10.7% (implying a safe harbor of 12.7%). Since OPCo's 2009 earned ROE of 9.42% is less than the safe harbor limit suggested by any of the witnesses in this proceeding, OPCo's 2009 earned ROE should not be subject to further SEET analysis. Further, because even the unadjusted 2009 ROE results for OPCo (10.81%) are below the safe harbor limit suggested by any of the witnesses in this proceeding, the question of whether OPCo's earnings fall within the safe harbor for 2009 does not depend on the Commission determining that OSS margins should be excluded from earned ROE for purposes of the SEET. Customer Group witness Kollen agreed that OPCo's earnings were within the safe harbor for 2009. (Tr. II at 405.)

B. CSP's 2009 earnings are not above the appropriate ROE threshold

CSP's 2009 earnings are not above the appropriate 2009 ROE threshold and the Commission should not make a finding that significantly excessive earnings existed for CSP in 2009. Based on Dr. Makhija's ROE threshold recommendation of 22.51%, there are no significantly excessive earnings either based on CSP's earnings that exclude OSS margins of 18.31% or its unadjusted, per books earnings of 20.84%. As discussed above, the Commission should exclude OSS margins from CSP's earnings and use the 18.31% for the starting point in applying the SEET statute.

C. The additional comparisons offered by OEG witness Kollen are irrelevant under the SEET statute and should be disregarded

Customer Group witness Kollen spends considerable effort in his testimony making irrelevant ROE comparisons. Specifically, Mr. Kollen compares CSP's return to four different groups: (1) other Ohio electric utilities, (2) other AEP-East operating companies, (3) regulated investor-owned electric utilities in the United States, and (4) traditional rate case decisions in 2009 involving electric utility companies. (Jt. Int. Ex. 2

at 18-21.) Each of these comparisons is irrelevant as a matter of law and should be disregarded. The SEET statute only provides for comparison of the electric distribution utility's return to earnings achieved during the same period by publicly traded companies, including utilities, that face comparable business and financial risk. The Customer Group sponsors testimony of Dr. Woolridge to address the appropriate comparable group analysis and it improperly attempts to advance the four extraneous comparisons through Mr. Kollen's testimony. Thus, the four additional comparisons should be wholly disregarded by the Commission in deciding this case.

As a threshold matter, Mr. Kollen readily agreed that he did not offer testimony regarding the appropriate rate of return for the group of firms facing comparable risks as CSP and that the scope of his testimony does not include addressing the comparable group. (Tr. II at 374.) Mr. Kollen also agreed that the analysis in his testimony did not address the ROE threshold and that the Customer Group was relying exclusively on Dr. Woolridge's testimony to establish the appropriate ROE threshold for 2009. (*Id.*) Moreover, he freely stated that he "simply was not familiar with and not testifying about" Dr. Woolridge's analysis of the comparable group returns or the level of returns above the comparable group that should be considered significantly excessive. (Tr. II at 375.) He did not even know whether Dr. Woolridge's comparable group reflected the shopping risk faced by CSP. (Tr. II at 423.) Thus, it is clear that the Customer Group's comparable group analysis (the only analysis permitted under the statute) is explained and supported through the testimony of Dr. Woolridge alone and that none of Mr. Kollen's comparisons are relevant.

The SEET statute, as well as the Commission's pertinent orders and rules, are the legal parameters that define the scope of this proceeding. None of those legal parameters allow the types of comparisons advanced in Mr. Kollen's testimony. The four sets of comparisons (other Ohio utilities, other AEP-East operating companies, investor owned electric utilities in the U.S. or utilities that happen to have had a traditional rate case decision in 2009) go beyond the SEET statute and do not relate to any of the criteria set forth by the Commission in its rules or in the June 30 Finding and Order or the August 23 Entry on Rehearing.

Even if the Commission were to somehow conclude that the four comparisons made by Mr. Kollen are not strictly irrelevant as a matter of law, each superfluous comparison is flawed factually and based on the lack of meaningful analysis performed by Mr. Kollen in his testimony. For example, Mr. Kollen explicitly admitted that he did not compare the business and financial risks of CSP to any of the companies involved in the four sets of extraneous comparisons. (Tr. II at 409, 414.) Similarly, he did not evaluate the shopping risk of other Ohio utilities as compared to CSP. (Tr. II at 425.) Mr. Kollen also failed to make reference to or distinguish any of the firms included in Dr. Woolridge's comparable group. (*Id.*) He also acknowledged that he did not examine the varied regulatory systems that apply to the AEP-East operating companies when developing his testimony comparing those companies in this proceeding. (*Id.*)

Mr. Kollen also failed to examine the regulatory systems of the 142 investor-owned utilities reflected in Ex. LK-3. (Tr. II at 413.) Importantly in the context of a consumer rate refund based on significantly excessive earnings, Mr. Kollen also admitted that he had not compared CSP's retail rates to any of the companies in the four extraneous comparison groups. (Tr. II at 410, 414.) Further, while he excluded the returns of one company that he happened to know faced unique regulatory circumstances, Mr. Kollen did not know whether other companies included in Ex. LK-3 faced unique regulatory circumstances. (Tr. II at 414-416.) Moreover, Mr. Kollen did not even know whether any of the 142 companies in Exhibit LK-3 faced shopping risk like CSP. (Tr. II at 416.)

Further, regarding his comparison in Ex. LK-5 of CSP to 39 electric utilities that happened to receive a rate case decision awarding a lower regulated return on equity, Mr. Kollen volunteered that "the only purpose" for an authorized rate of return would be in a regulated type of environment. (Tr. II at 417.) Thus, he effectively admitted that these companies were traditionally regulated and that LK-5 compares authorized ROE in those traditional rate cases to application of the SEET statute in Ohio – an inapposite comparison. The suggestion that a return used in a traditional ratemaking is even close to the concept of significantly excessive earnings totally misses the mark. Regarding these rate case decisions, Mr. Kollen did not compare the business and financial risks of the involved companies to CSP's and acknowledged that he had no familiarity with their retail rates as compared to CSP, nor did he even know how many might be vertically-integrated utilities. (Tr. II at 417-418.) In sum, Mr. Kollen's extraneous comparisons are irrelevant as a matter of law and, in any case, are clearly superficial and fundamentally flawed. As such, they lack evidentiary value and should not be considered. The only pertinent comparisons are to the group of firms that faced comparable business and financial risks to CSP.

V. Treatment of Regulatory Accounting Deferrals

As discussed in AEP Ohio witness Hamrock's testimony, the Companies submit that it is inappropriate for the Commission to consider refunding earnings based on revenue that has not actually been collected from customers. (Cos. Ex. 6 at 13.) If the Commission uses a different ROE threshold and/or uses a different earned return in applying the SEET statute, then the Commission might also need to exclude the "paper earnings" associated with CSP's fuel and economic development earnings – this approach further reduces CSP's 2009 earnings to 15.99%. (Cos. Ex. 4 at 12.) Whether the Commission needs to exclude the deferrals depends on what ROE threshold it adopts and what 2009 earnings for CSP are used in applying the SEET statute. For example, if the Commission adopts Staff witness Cahaan's ROE threshold of 16.05%, both the OSS and deferral adjustments should be employed to help avoid a finding of significantly excessive earnings.[5] In any case, the deferral earnings associated with fuel costs and the economic development discounts that the Commission concludes result in significantly excessive earnings in 2009 should only be considered during the subsequent period when the revenues are actually collected from customers if earnings are significantly excessive.

[5] This is just one of many examples of possible outcomes in this case and AEP Ohio realizes that Staff witness Cahaan disputes the quantification of AEP Ohio's earnings adjustments for OSS and deferrals (the Companies disagree with Mr. Cahaan's analysis regarding the adjustments, as well as his recommended ROE threshold, and address those issues separately). But it is possible that the Commission would accept the Companies' adjustment calculation while adopting the Staff's ROE threshold. In any case, as discussed further below, the SEET statute requires qualitative consideration of capital requirements of future committed investments in Ohio prior to making any finding of significantly excessive earnings based on such a quantitative analysis.

As Companies witness Hamrock testified, the SEET should not be applied in a manner that undermines the probability of future recovery of deferrals previously authorized. That would jeopardize the EDU's ability to create the deferrals in the first place, and the Commission's ability to implement rate increase phase-ins when appropriate. (Cos. Ex. 6 at 15.) It would also be contrary to the policy that Section 4928.144, Revised Code, promotes of allowing phase-ins and the recovery by EDUs of the underlying deferrals. The same principles apply to both the fuel deferrals and the economic development deferrals: an EDU should not be required to return to consumers amounts that it has not yet collected from them.

Companies witness Mitchell calculated the total deferrals to be $47.2 million for CSP and $305.2 million for OPCo. (Cos. Ex. 4, Ex. TEM-6.) The after-tax effect of excluding the deferrals would be to further reduce the ROE from 18.31% and 9.42% for CSP and OPCo, respectively, to 15.99% and 2.54%. (*Id.*) Mr. Mitchell's calculation of earnings with and without deferrals is consistent with the Commission's directive on page 18 of the June 30 Finding and Order, wherein the Commission explicitly determined that it would consider deferral adjustments in individual utility cases and directed utilities to quantify the effect of excluding deferrals from the SEET calculation.

Significant deferrals should be included in the calculation of the EDU's earnings and return on equity as well in those of the comparable risk group's members (that face similar business and financial risks) because those deferrals make the firms comparable. However, if it is determined that the EDU has significantly excessive earnings, in comparison to the return on equity of the comparable group, it would be appropriate to eliminate the significant deferrals included in the earnings in the course of making the determination of whether, or to what extent, earnings should be returned to consumers. The basis for this position is simple. An EDU that is deemed to have excessive earnings that also has significant deferrals should not have to refund amounts that it has not yet received; nor should it have to refund amounts that are merely a recovery of costs and do not, by themselves, contribute to earnings.

Significant deferrals recovered in the future are an accounting entry that recognizes the future right of the EDU to collect from customers its unrecovered deferred expense. It does not represent the recovery of those deferred expenses. It merely matches the unrecovered expense in the deferral accounting period with the revenues recovering that expense in the future accounting period(s) in which the revenues are collected, thereby making the EDU's earnings comparable to those of Companies without unrecovered deferrals. The proper matching of cost and revenue is also necessary to reflect the economics of cost-based rate making in the financial statements; however, the resultant non-cash deferral credits (the IOU from the customers) should not be subject to being refunded (as if they were cash in hand, which they are not).

If the EDU is determined to have significantly excessive earnings in comparison to the comparable risk group and makes an adjustment to remove deferrals in the year(s) of deferrals for determining the appropriate amount of earnings that should be returned to consumers under the SEET, then in the year(s) that the deferrals are collected (when the related cash is received), if the EDU has significantly excessive earnings in that year, an adjustment should also be made to exclude the amortization of the deferral expenses, thereby appropriately including in the amount subject to being refunded just the recovered revenues recognized in the SEET.

VI. Earnings from only four of the Companies' ESP rate adjustments are subject to refund in those adjustments caused significantly excessive earnings in 2009

The scope of the SEET under R.C. 4928.143(F) extends only to significantly excessive earnings resulting from rate increases included in an approved ESP. The earnings from ESP adjustments potentially subject to a remedy/return to customers are limited to: tariff rate increases, authorized by the ESP, paid by customers during 2009, and that directly produced earnings (*i.e.*, not ESP adjustments that simply provide for the recovery of costs). This has been referred to as the "refund cap" or the "SEET cap" in the record of this proceeding (*E.g.*, Tr. I at 62; Tr. II at 256, 401, 405; Tr. IV at 662-663.), but that label is somewhat imprecise – because there are other important conditions that apply before the Commission could conclude that significantly excessive earnings were the result of those earnings-producing rate adjustments and some or all of those dollars are subject to refund.

In particular, the SEET under R.C. 4928.143(F) only encompasses significantly excessive earnings that *result from* rate adjustments included as part of an approved ESP. *See* June 30 Finding and Order at 14 ("Based on the clear, unambiguous language of the statute, the Commission is directed to analyze whether the ESP is the cause of the EDUs significantly excessive earnings.") The Commission directed electric utilities "to include in their SEET filings the *difference in earnings* between the ESP and what would have occurred had the preceding rate plan been in place." June 30 Finding and Order at 15 (emphasis added). Thus, the earnings from ESP adjustments potentially subject to a remedy/return to customers, in the event the Commission finds that the EDU's earned ROE significantly exceed the SEET benchmark ROE over the same period, are limited to: tariff rate increases, authorized by the ESP, paid by customers during 2009, and that directly produced earnings (*i.e.*, not ESP adjustments that simply provide for the recovery of costs). (Cos. Ex. 6 at 11.)

Rate adjustments that merely pass through costs incurred do not provide new earnings opportunities for an EDU. Rather, such rate adjustments avoid the effect on earnings that might otherwise be caused by changes in those expenses. Returning any portion of those revenues to customers would cause the Companies to under-recover the expenses actually incurred and that would defeat the purpose of the rider involved. The primary purpose of such rate adjustment mechanisms is to remove the impact on earnings by merely passing through a specific cost of providing service.

Linking the recovery of such costs to earnings would erode the viability of those cost recovery mechanisms. Because ESP provisions that allow for rate adjustments that recover costs did not change the earnings that were achieved pursuant to the prior regulatory regime, they do not result in additional earnings and, by definition, do not cause significantly excessive earnings. Such adjustments are not eligible for remedy/return to customers in the event the EDU's earned ROE exceeds the SEET benchmark.

The Commission's June 30 Finding and Order also found (at pages 14-15) that "the clear, unambiguous language of the statute limits the amount of any refund to customers to the adjustments in the current ESP." Again, the Commission (at page 15) directed electric utilities to include in their SEET filings the *difference in earnings* between the ESP and what would have occurred had the preceding rate plan been in place. On rehearing, the Commission did not modify the comparison requirement but merely clarified (at page 5) that it would not need to be done for an EDU whose return on equity falls within the safe harbor limit. Accordingly, this comparison requirement need not be done for OPCo in connection with its 2009 filing. Calculating the total 2009 earnings resulting from the earnings-producing rate adjustments authorized under the ESP, as AEP Ohio witness Mitchell did at Mr. Hamrock's request, directly quantifies the difference in earnings between the ESP and what would have occurred had the preceding rate plan been in place. Thus, Mr. Mitchell's calculations in this regard capture the incremental earnings resulting from the ESP, beyond the level authorized under CSP's preceding rate plan.

As discussed in Companies witness Hamrock's testimony, CSP's ESP adjustments that would be subject to remedy/return to customers would be limited to:

1. Equity return on incremental 2001-2008 environmental investments;
2. Equity return on the Enhanced Service Reliability rider investments;
3. Equity return on gridSMART^{sm} investments; and
4. incremental POLR revenues over and above CSP's pre-ESP POLR charges.

(Cos. Ex. 6 at 13.) Companies witness Mitchell calculated CSP's earnings associated with the four above-listed ESP adjustments. CSP's 2009 total after-tax earnings associated with the four adjustments are $59.6 million, which corresponds to a pre-tax revenue amount for 2009 of $93.0 million. (Cos. Ex. 4 at 6-7.)

Customer Group witness Kollen advocated a higher amount of earnings subject to the SEET based on the erroneous assertion that "[e]ach new dollar collected from consumers pursuant to the ESP increased earnings by the same amount." (Jt. Int. Ex. 2 at 14.) Specifically, Mr. Kollen advocates a refund cap of $156 million. (*Id.* at 13.) The two differences between the $93 million cap calculated by Companies witnesses Hamrock and Mitchell and the higher $156 million cap recommended by Mr. Kollen are his: (1) inclusion of the fuel deferrals, and (2) inclusion of all rider revenues (versus just the earnings) from the enhanced service reliability rider, the environmental investment carrying charge rider and the gridSMART rider. (Tr. II at 401-402.) Both of the two additional categories included by Mr. Kollen in his refund cap are based on his flawed theory that "[w]hen a utility is authorized to increase rates by $1 dollar [sic] – because its costs went up, its sales went down, or for any other reason – earnings are increased by $1 dollar [sic] and are higher than they otherwise would have been." (Jt. Int. Ex. 2 at 14.)

First, regarding Mr. Kollen's inclusion in his refund cap of the "paper earnings" associated with CSP's fuel deferral, the FAC mechanism approved for implementation beginning in 2009 merely passes through prudently-incurred fuel costs. Regardless of whether a particular portion of the FAC costs was recovered during 2009 or deferred during 2009, the FAC revenues do not exceed prudently-incurred costs and should not be considered earnings that are subject to refund under the SEET. Moreover, as referenced above, it is particularly inappropriate to advocate that CSP refund revenues that have not even been collected from customers. Thus, neither FAC revenues nor deferrals should be considered as earnings-producing rate increases that comprise the refund cap.

Additionally with respect to the fuel deferrals, Mr. Kollen's position fails to recognize that the Commission established an FAC baseline when it adopted the FAC mechanism commencing in 2009. (*ESP Cases*, Opinion and Order at 19.) In adopting the FAC baseline, Commission's decision was based on the presumption that CSP's existing fuel costs were already being recovered during the pre-ESP rate plan and involved unbundling of fuel and non-fuel components of the generation rate. In other words, the Commission backed out the existing level of fuel costs from the formerly bundled generation rate when it implemented CSP's new fuel clause. This fact directly undermines Mr. Kollen's faulty premise that "every new dollar in rates is a new dollar in earnings" – the 2009 dollars in the FAC were not "new" but were actually a replacement of the dollars already embedded in the existing generation rates. Consequently, Mr. Kollen's recommendation regarding inclusion of fuel deferrals in the refund cap should be rejected.

Second, with respect to the ESR and gridSMART riders for which Mr. Kollen included all revenues and Mr. Mitchell only included new earnings in the refund cap, it is simply not the case that the costs incurred in connection with either of those riders would have been incurred absent their approval by the Commission and inclusion in CSP's ESP. As Companies witness Hamrock testified on rebuttal, absent pre-approval to recover prudently-incurred costs associated with the initiatives, CSP would not have undertaken those projects and would not have incurred the costs that are being offset through the revenues realized under those riders. (Cos. Ex. 8 at 4.) Now that the projects have been initiated and costs have been incurred, it is particularly unfair for Mr. Kollen to advocate offsetting the revenues realized by CSP as earnings that can be clawed back under the SEET.

Regarding the environmental investments carrying charge rider (EICCR), the ESP Order approved a carrying charge that includes depreciation, federal income taxes, property taxes, administrative expense as well as a debt and equity return. (Cos. Ex. 4 at 8.) Mr. Mitchell calculated the return on equity component and appropriately included it in his refund cap, as that is the only earnings component of the EICCR. (Cos. Ex. 4, Ex. TEM-2.) Thus, it is evident that Mr. Kollen's attempt to encompass the entire EICCR revenue realization within the refund cap is also inappropriate. Rather, it is only appropriate to include the earnings portion of the rider revenues – as was done in Mr. Mitchell's calculations in support of the $93 million refund cap.

VII. Section 4928.143(F), Revised Code, requires the Commission to consider CSP's capital requirements of future committed investments in Ohio prior to making any determination that significantly excessive earnings exist

The statutory language in Section 4928.143(F), Revised Code, provides the Commission with flexibility to consider the EDU's upcoming capital requirements when determining whether significantly excessive earnings exist. Specifically, the statute gives the Commission the latitude to determine that if the EDU has capital spending commitments that it must meet in the near future, its earnings should not be considered significantly excessive. That language would also allow the Commission to permit an EDU to retain earnings that might otherwise be considered to be significantly excessive, under the implied theory that the EDU could use them to meet its capital spending requirements for the future committed investments. AEP Ohio submitted evidence of its $1.67 billion capital investment in Ohio during the ESP. There is no basis in the statute to support parties' position that AEP Ohio's capital budget plan is inadequate for consideration and that the capital commitment needs to be (i) "exceptional" or "unusual" in nature (Tr. II at 289-290), (ii) firmly established without any conditions, or (iii) an investment that will not be recovered in future rates. Rather, the clear and unambiguous language in the SEET statute allows the Commission to avoid a finding of significantly excessive earnings based on the capital requirements of future committed investments in Ohio. In any event, CSP has also committed to make exceptional incremental capital investments in Ohio involving a large solar farm, substantial environmental investments and expansion of its gridSMART initiative – all of these commitments should be considered by the Commission as necessary to avoid a finding of significantly excessive earnings for CSP in 2009.

Rule 4901:1-35-03(C)(10)(a)(iii), OAC, requires that with the annual SEET filing during an ESP term, the EDU must provide "[c]apital budget requirements for future committed investments in Ohio for each annual period remaining in the ESP." This rule provision reinforces the notion that capital budget forecasts are indicative of the EDU's "capital requirements for future committed investments." Requiring capital budget forecasts for review in this context certainly does not suggest that a capital commitment must be extraordinary or firmly established without condition, in order to be considered in this context.

AEP Ohio submits that it has presented substantial evidence of the capital requirements its future investments in Ohio and that it is appropriate for the Commission to recognize that retained equity is needed in order to enable those plans to materialize in the future. Companies witness Hamrock presented AEP Ohio's actual and projected annual capital expenditures for 2007 through 2011 are contained in Exhibit JH-1 to his testimony. (Cos. Ex. 6, Ex. JH-1.) Exhibit JH-1 shows that AEP Ohio has planned capital investments of approximately $1.67 billion during the ESP term alone. By any measure, this is a substantial capital investment in Ohio and should carry significant weight in the Commission's 2009 SEET analysis for AEP Ohio. Mr. Hamrock testified that the data reflected in Exhibit JH-1, presenting three years of actual historical information and two years of projected information, gives an accurate picture of AEP Ohio's present and future capital investments in Ohio during the ESP term. (Cos. Ex. 6 at 17.) The three years of actual data for 2007-2009 and the 2010 projected data agree with total construction expenditures per AEP's December 31, 2009 10-K Form submitted to the Securities and Exchange Commission. (*Id.*)

Mr. Hamrock discussed a discovery response from AEP Ohio (OCC Ex. 8, Response to OCC INT-004, including Attachment 1) that was admitted into the record. (Tr. II at 188, 309.) The discovery response, provided by AEP Ohio, explained the AEP process for approval of capital expenditures as reflected in Ex. JH-1 attached to Mr. Hamrock's testimony:

> AEP Policy requires that every capital project be approved by functional management and the subsidiary's Board of Directors before the project begins. The same approvals are required when project revisions occur in accordance with AEP Policy. Projects start at various times and can last more than one year, so some projects are approved in previous years. The majority of the dollars in the 2010 forecast, as well as a substantial portion of the 2011 forecast have already been approved by management and the company's board of directors.

(OCC Ex. 8 at 2.)

During cross examination, Mr. Hamrock further explained that approximately 90% of the projects listed in Ex. JH-1 for 2010 have already been approved by management and for 2011 the approvals have occurred for 70-80% for 2011. (Tr. II at 194; Tr. III at 303.) Hence, even if one were to conservatively use only the actual 2009 capital expenditure and pro-rated 90% for 2010 and 70% for 2011 using the data in Ex. JH-1, this still equates to $641.4 million management-approved capital commitment for CSP during the ESP period. By any measure, this is a substantial capital investment in Ohio that should carry significant weight in the Commission's 2009 SEET analysis for CSP.

Mr. Hamrock's direct testimony also indicated that AEP Ohio is currently planning a long-term infrastructure investment plan to present as part of its next distribution rate case before the Commission. (Cos. Ex. 6 at 17-18.) This plan involves an additional capital investment in Ohio expected to exceed $1 billion. This plan includes expansion of CSP's gridSMART program, which is responsive to state policy and growing customer interest in enhanced information, advanced control, and improved reliability and environmental performance. AEP Ohio anticipates filing this plan early in 2011. While this comprehensive plan is not yet before the Commission, let alone approved for timely recovery through rates, it nonetheless further demonstrates that AEP Ohio continues to escalate its capital commitment to investment in Ohio.

In his rebuttal testimony, Mr. Hamrock testified as follows concerning CSP's additional capital investments (above and beyond the capital budget information contained in Ex. JH-1):

> CSP is planning for substantial capital requirements associated with future committed investments in Ohio for environmental and renewable mandates. In particular, CSP has substantial capital requirements for future committed investments in meeting new environmental requirements that are not reflected in the projects that support Exhibit JH-1. In addition, CSP is committed to future capital investments to help fulfill its alternative energy portfolio requirements

> under R.C. 4928.64. For example, CSP has committed to support the development of a very large solar farm near Cumberland, Ohio by making a $20 million equity investment in the project. Moreover, as previously indicated in its ESP testimony, CSP is committed to expanding its gridSMART project to its entire service territory – a substantial undertaking that is capital-intensive. CSP believes that all of these capital requirements for environmental, renewable and gridSMART projects should be considered by the Commission.

(Cos. Ex. 8 at 7.) Thus, CSP is making a substantial capital commitment that is above and beyond its more routine capital budget plans.

The solar farm investment and the gridSMART expansion, in particular, are initiatives that CSP would not need to undertake in the normal course of business. CSP could simply choose to buy RECs at market prices and pass them through to customers, as permitted by Section 4928.65, Revised Code. Similarly, CSP is not required to pursue gridSMART investment. More importantly, there are aspects of both the solar farm investment and gridSMART initiatives that go well beyond the direct economic benefit of investing those dollars in the Ohio economy. For example, Cos. Ex. 9 indicates that as many as 600 jobs would be created by the solar farm project. And Mr. Hamrock testified more generally that any capital investment in Ohio could bring new tax base, new jobs, increased support for the broad range of customers is beneficial to all the state's residents. (Tr. II at 252.)

These kinds of benefits are very real and the capital investments that result in such benefits should be considered in this case. Specifically, even beyond the substantial level of "normal" investment made in Ohio by CSP (at least $641.4 million during the ESP), CSP has also committed to make exceptional incremental capital investments in Ohio involving a large solar farm (*e.g.*, a $20 million equity investment), substantial environmental investments and expansion of its gridSMART initiative. All of these capital commitments should be considered by the Commission as necessary to avoid a finding of significantly excessive earnings for CSP in 2009.

VIII. Additional Factors that the Commission indicated it would consider

As indicated on page 29 of its June 30 Finding and Order, there are several additional factors that the Commission indicated it would also consider in this regard prior to concluding that significantly excessive earnings exist during a particular time period for a specific utility. Besides capital requirements of future committed investments in Ohio (the consideration of which is required by statute as discussed above), the Commission indicated that such additional factors include, for example: (1) the electric utility's most recently authorized return on equity; (2) the electric utility's risk, including whether the electric utility owns generation, whether the ESP includes a fuel and purchased power adjustment or similar mechanism, the rate design and the extent to which the electric utility remains subject to weather and economic risk; (3) indicators of management performance and benchmarks to other utilities; (4) innovation and industry leadership with respect to meeting industry challenges to maintain and improve the competitiveness of Ohio's economy, including research and development expenditures, investments in advanced technology and innovative practices; and (5) the extent to which the electric utility has advanced state policy. These factors were each addressed in AEP Ohio's filing and will be briefly discussed next.

A. The most recently authorized return on equity

It has been 19 years since the time CSP filed its last general rate case and 16 years since the time of OPCo filed its last general rate case. Although the return on equity authorized in those prior general rate cases might align with a utility's present required return on equity when viewed under the lens of traditional regulation, the return on equity approved in those cases is based on stale data and supporting information and any such alignment would be coincidental. As a related matter, any current return on equity considerations should reflect the new risks attendant to an electric utility operating under the new hybrid form of regulation in Ohio. Moreover, the statutory language in the SEET ties the determination of significantly excessive earnings to earnings attained by a comparable group of companies facing the same business and financial risks and would not permit any direct consideration or critical reliance on previously-authorized return on equity established in a traditional, general rate case involving a vertically integrated utility prior to the advent of customer choice in Ohio.

B. The electric utility's risk, including whether the utility owns generation, whether the ESP includes a fuel and purchased power adjustment or similar mechanism, the rate design and the extent to which the electric utility remains subject to weather and economic risk

As Companies witness Hamrock testified, Ohio electric utilities such as CSP and OPCo that own generation assets bear additional risks as compared to utilities that do not own generation assets. (Cos. Ex. 6 at 20.) The generation-owning utilities in Ohio are no longer guaranteed recovery of their substantial capital-intensive assets. Rather, under SB 221, the competitive nature of generation service created a shopping and customer migration risk. Given the "hybrid" nature of SB 221, this risk goes beyond the risk presented in other retail choice states. A detailed list of these unique business and financial risks is contained in Exhibit JH-2 attached to Mr. Hamrock's testimony. (Cos. Ex. 6, Ex. JH-2.)

This is especially true for generation-owning utilities such as CSP and OPCo that operate under an ESP, given that the approval standard can be applied as the lower of market or cost. Moreover, individual utilities face specific risks based on the terms of their ESP. For example, AEP Ohio's approved ESP incorporates the risk of an unanticipated shutdown of generating stations between 2009 and 2011.[6]

The hybrid and experimental nature of SB 221 may also present another risk for generation-owning utilities, through the prospect of additional future industry restructuring and uncertainty. There are additional inherent risks of fossil-based regulation for utilities like CSP and OPCo – relative to the prospect of carbon regulation and uncertain future market prices for generation-related services. Of course, the ever-increasing panoply of environmental regulations that apply to fossil generation also creates another distinct substantial capital-intensive challenge and associated uncertain future market price impact for generation-related services.

Regarding rate design, CSP's and OPCo's revenue stream from retail rates is also subject to variation and uncertainty based on weather risk and other economic factors – such as those currently being experienced – that cause load to fluctuate substantially over time. (Cos. Ex. 6 at 20.) While CSP's and OPCo's ESP rates presently include a fuel and purchased power cost recovery mechanism that includes recovery of environmental system consumables costs and renewable power purchases required by SB221, those mechanisms are bypassable by customers, thus exposing the Companies to market risks for those substantial costs. (*Id.*)

[6] See AEP Ohio *ESP Cases*, March 18, 2009 Opinion and Order at 53.

All of these additional risks applicable to CSP and OPCo should be considered by the Commission in implementing the SEET. In this SEET proceeding, the Commission should carefully consider and recognize these risks and balance them against the associated expectation by investors of returns commensurate with these risks. The appropriate balance will ensure the ability to attract future capital investment to Ohio for critical infrastructure needs.

C. Indicators of management performance and benchmarks to other utilities

As Companies witness Hamrock testified, AEP Ohio uses key indicators to gauge the company's performance, including quarterly customer satisfaction tracking studies for both residential and small commercial customers and distribution reliability indices. (Cos. Ex. 6 at 20-21.) Since 2005, AEP Ohio has consistently ranked in the first quartile for overall satisfaction with residential customers when compared to a robust national peer group. In 2009, AEP Ohio ranked in the first decile for overall satisfaction with small commercial customers. (*Id.* at 21.) The company's reliability indices have followed a similar trend, improving steadily since 2003 in both frequency and duration of outages. For example, the System Average Interruption Frequency Index (SAIFI) in 2003 for CSP and Ohio Power was 1.95 and 1.21 respectively. In 2009, SAIFI was 1.31 for CSP and 0.91 for Ohio Power. (*Id.*) Both companies' Customer Average Interruption Duration Index (CAIDI) has shown similar improvements. In 2003, CAIDI was 148.6 for CSP and 174.7 for Ohio Power. Last year, CAIDI improved to 122.6 for CSP and 133.4

for Ohio Power.[7] (*Id.*) These improvements have been made while maintaining some of the lowest rates in the region. (*Id.*)

D. Innovation and industry leadership with respect to meeting challenges to maintain and improve competitiveness of Ohio's economy, including research and development expenditures, investments in advanced technology and innovative practices

As Companies witness Hamrock testified, for more than a century, AEP Ohio has been a pioneer of industry-leading advances in electricity generation and transmission technologies that have dramatically improved the reliability, cost effectiveness, and environmental performance of the power grid. (Cos. Ex. 6 at 21-22.) AEP Ohio's leadership and the associated investments have long been a source of benefits for Ohio in several ways including; a secure and reliable supply of low cost electricity to power Ohio's manufacturing economy, a steady stream of investment that have maintained a significant tax base throughout the state, and a total economic impact that well exceeds $2 billion per year including payroll for thousands of Ohioans, and purchases of Ohio goods and services. (*Id.*) Today AEP Ohio's leadership extends into the distribution segment of the business through the industry-leading gridSMART initiative. In collaboration with the Commission and the United States Department of Energy, CSP's gridSMART Demonstration project is well on the way to implementation of the first phase of new customer programs and technologies that are designed to modernize the distribution system and significantly enhance customers' ability to save energy and money through informed energy decisions and controls. (*Id.* at 21.) The CSP gridSMART Demonstration Project will provide a platform for ongoing innovation by

[7] Historical values were calculated using the new reporting guidelines under IEEE 1366.

effectively integrating commercially available products, new technologies and new consumer products and services within a single, secure two-way communication network between the utility and its consumers.

Mr. Hamrock testified that the gridSMART Project, receiving the highest rating among all demonstration grant applications to the U.S. Department of Energy, is a holistic approach to advancing smart grid development, by testing some of the most advanced smart grid technologies in central Ohio. (Cos. Ex. 6 at 22.) AEP Ohio brings leadership in industry and technical innovation to this project. AEP's Columbus-based Dolan Technology Center has an established smart grid test bed providing a platform to gain experience with smart grid components that will facilitate electric distribution system performance and customer service. AEP also participates in various industry efforts aimed at strengthening interoperability standards and cyber security, notably the National Electric Reliability Council (NERC) Critical Infrastructure Protection (CIP) standards development team and National Institute of Standards and Technology (NIST) development work on smart grid interoperability. (*Id.*)

In addition, with greenhouse gas emission limits anticipated in the future, AEP Ohio's parent company, American Electric Power, has collaborated with the United States Department of Energy on an industry-leading carbon capture and sequestration project at Appalachian Power's Mountaineer plant. Demonstration of such technologies by AEP can ultimately lead to technology and knowledge transfer to AEP Ohio.

E. The extent to which the electric utility has advanced state policy

In response to SB 221, Mr. Hamrock testified that AEP Ohio took the lead on implementing energy efficiency and demand reduction programs that have the potential to save Ohio consumers and businesses approximately $630 million in reduced bills over the life of the programs and reduce power plant emissions. (Cos. Ex. 6 at 23.) As its Portfolio Status Report[8] indicates, AEP Ohio's energy efficiency and peak demand response programs were very successful in 2009, achieving the benchmark requirements for both areas. For energy efficiency programs, CSP achieved 202 percent of its benchmark requirement while Ohio Power achieved 171 percent. (*Id.*)

AEP Ohio has also contributed to the development of an emerging solar power industry in Ohio by bringing to the state Ohio's first utility scale solar generation facility located near Upper Sandusky in Wyandot County. (*Id.*) The project officially began generating renewable solar power on a commercial basis on May 16, 2010. The project was a direct result of AEP Ohio's commitment to buy all of the facility's 10 megawatt output through a 20-year power purchase agreement. (*Id.*)

[8] AEP Ohio's compliance report for 2009 was filed in March 2010, in Case Nos. 10-318-EL-EEC and 10-321-EL-EEC.

CONCLUSION

For the foregoing reasons, the Commission should find that OPCo and CSP have demonstrated that neither company had significantly excessive earnings in 2009.

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PROOF OF SERVICE

I certify that Columbus Southern Power Company's and Ohio Power Company's Initial Brief was served by electronic mail upon counsel for all parties of record identified below this 19th day of November, 2010.

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