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EXHIBIT NO._________

BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application of Columbus Southern Power Company and Ohio Power Company for Authority to Establish a Standard Service Offer Pursuant to §4928.143, Ohio Rev. Code, in the Form of an Electric Security Plan.	)	Case No. 11-346-EL-SSO Case No. 11-348-EL-SSO
In the Matter of the Application of Columbus Southern Power Company and Ohio Power Company for Approval of Certain Accounting Authority	)	Case No. 11-349-EL-AAM Case No. 11-350-EL-AAM

DIRECT TESTIMONY OF
MICHAEL J. KELLEY
ON BEHALF OF
COLUMBUS SOUTHERN POWER COMPANY
AND
OHIO POWER COMPANY

Filed: July 1, 2011

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DIRECT TESTIMONY OF
MICHAEL J. KELLEY
ON BEHALF OF
COLUMBUS SOUTHERN POWER COMPANY
AND
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Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND POSITION.

A. My name is Michael J. Kelley. My business address is 1 Riverside Plaza, Columbus, Ohio 43215. I currently hold the position of Director, Tax Planning & Analysis, in the Tax Department of American Electric Power Service Corporation (AEPSC), a subsidiary of American Electric Power Company, Inc. (AEP).

Q. PLEASE BRIEFLY DESCRIBE YOUR EDUCATIONAL AND BUSINESS EXPERIENCE.

A. I earned a Bachelor of Business Administration Degree in Accounting from The University of Tulsa in 1982, a Bachelor of Science in Curriculum and Instruction (with Math and Physics) from Texas A&M University in 1973 and a Master of Education in Education Psychology from Texas A&M University in 1974. I am a Certified Public Accountant and have been certified in Oklahoma since 1983. I am also a member of the American Institute of Certified Public Accountants and the Tax Executives Institute. In 1974, I entered the United States Air Force as a Second Lieutenant and left in 1978 as a First Lieutenant. In 1978, I began work in the accounting and tax area at the Tom Walters Company in Tulsa, Oklahoma where I provided both tax and accounting services for various individuals and small businesses. In 1990, I joined Central and South West Corporation ("CSW") at its gas pipeline subsidiary, Transok, Inc. At Transok and later at Central and South West Service Corporation, I served in various positions within the tax area including the position as Manager of Tax Planning. In this position I was responsible for both domestic and international tax planning and international tax compliance. When CSW merged with AEP in 2000, I was promoted to my current position of Director, Tax Planning and Analysis.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE ANY REGULATORY COMMISSIONS?

A. Yes. I have provided both written testimony and verbal testimony before the Louisiana Public Service Commission with regard to the Southwestern Electric Power Company rate review conducted pursuant to Merger Order U-23327 – Docket No. U-23327 Sub docket A and the Public Service Commission of the Commonwealth of Kentucky in the matter of Kentucky Power Company's second amended environmental compliance plan and second revised tariff – Case No. 2005-00068. I also provided rebuttal testimony on behalf of Appalachian Power Company before the Public Service Commission of West Virginia in Case No. 06-0033-E-CN.

Q. DID YOU SUBMIT DIRECT TESTIMONY IN THIS PROCEEDING?

A. No.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to expand upon the testimony of the Company witness Jay F. Godfrey as to tax issues related to this transaction. Additionally, I will explain the tax normalization issues that must be settled in order to qualify for the thirty (30) percent investment tax credit allowed pursuant to Internal Revenue Code

(IRC) §48. I will discuss the Internal Revenue Service's (IRS) requirements for a Commission order allowing for this Project that, in turn, will allow AEP to request a private letter ruling that this transaction does not violate the normalization requirements of the IRC. Finally, I will address if the project qualifies for bonus tax depreciation.

Q. WILL THE LEASES BE CLASSIFIED AS CAPITAL LEASES FOR TAX PURPOSES?

A. Yes. As Company witness Godfrey stated, there will be three leases - one for each phase of the project. The leases will be for twenty-five (25) year terms and AEP Ohio will be solely responsible for the operation and maintenance of the Project. These Projects may be acquired by AEP Ohio at the end of each lease term for a purchase price of $1 for each phase. Based on the facts and circumstances, we have determined that these leases are not true leases for the tax purposes, but are correctly classified as capital leases.

Q. **AS TAX CAPITAL LEASES, WHAT TAX BENEFITS ARE AVAILABLE TO AEP OHIO?**

A. If the property is classified as public utility property and the requisite tax normalization requirements are met, then AEP Ohio will be able to claim the thirty (30) percent IRC §48 investment tax credit (ITC) and use 5-year accelerated tax depreciation.

Q. PLEASE DEFINE PUBLIC UTILITY PROPERTY.

A. Public utility property includes, in part, property used predominantly in the trade or business of the furnishing or sale of electrical energy services if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.[1]

Q. ARE THESE PROJECT ASSETS PUBLIC UTILITY PROPERTY?

A. In my opinion, the Project will be public utility property, and AEP Ohio intends to have this issue addressed in the IRS private ruling request discussed below.

Q. PLEASE DESCRIBE THE NORMALIZATION REQUIREMENTS THAT MUST BE MET TO QUALIFY FOR THE §48 INVESTMENT TAX CREDITS.

A. After the proposed merger of Ohio Power Company and Columbus Southern Power Company, the merged companies (AEP Ohio) will treat its ITC pursuant to former IRC §46(f)(1) method currently used by Ohio Power Company. AEP Ohio will reduce rate base by the unamortized IRC §48 ITC balances. To meet the normalization requirements, the benefit of the ITC must not be provided to the ratepayers any more rapidly than ratably. Since the books will also treat the leases as capital leases and will depreciate the facilities over the twenty-five year term of the lease on a straight-line basis, the ITC must also be amortized on a straight-line basis over the same twenty-five year term (i.e. the life of the assets). It is important to remember that, under Ohio Power's §46(f)(1) method, ITC is not a direct benefit to ratepayers, but the benefit is provided as a reduction to rate base that amortizes to zero over the book life of the asset.

[1] The definition of "public utility property" is found in IRC §168(i)(10) and this definition is stated again in Reg. §1.46-6(b)(1) as part of the description of §46(f). Current IRC §50 makes reference to the relative provisions of §46 in place before amendment to the IRC by P.L. 101-508.

Q. DOES AEP OHIO HAVE NORMALIZATION REQUIREMENTS RELATED TO THE USE OF ACCELERATED TAX DEPRECIATION? IF SO, PLEASE EXPLAIN.

A. Yes. AEP Ohio must record deferred income tax expense related to the timing differences of book and tax depreciation. Rate base will be reduced by the accumulated deferred income tax liability (DFIT) generated by the excess of accelerated tax depreciation over straight-line book depreciation. As with the ITC, this rate base reduction is adjusted yearly. During the first six years of each phase, the DFIT will grow to produce a large rate base adjustment. Thereafter, the DFIT will amortize to zero over the remaining book life of the asset. If AEP Ohio does not meet this normalization requirement, AEP Ohio will only be allowed to claim straight-line tax depreciation on these facilities using a twenty-five year life. This disallowance of accelerated tax depreciation will result in the complete elimination of the DFIT benefit to the ratepayers.

Q. WHAT OTHER NEGATIVE IMPACTS WOULD IMPACT AEP OHIO AS A RESULT OF A NORMALIZATION VIOLATION?

A. A normalization violation would trigger the recapture of all unamortized ITC previously claimed by AEP Ohio and would bar AEP Ohio from claiming future ITC.

Q. HOW DOES AEP OHIO PROPOSE TO PROVIDE TO RATEPAYERS THE BENEFITS FROM THE ITC AND ACCELERATED TAX DEPRECIATION?

A. The nonbypassable charge will include, in part, the lease payments which will be offset by 1) the interest received by AEP Ohio on its loans to TPS Generation and 2) by the same benefit that would have been generated by a reduction of rate base from accumulated DFIT. The loans to TPS Generation will generally be made using the cash generated by the ITC when each phase is placed in service.

Q. COULD EITHER OF THESE TWO REDUCTIONS RESULT IN A NORMALIZATION VIOLATION?

A. Yes. When we look to the §1.46-6 regulations, we find a provision that states that we cannot do indirectly that which we could not do directly.[2]

It is unclear if the use of interest earned on the loans to TPS Generation to reduce the charge to ratepayers could result in a normalization violation. There are two issues related to the loans that need to be resolved with the IRS. The first issue is "Does the use of the interest on the loans to reduce the charge result in "flowing" the benefits of the ITCs to the ratepayer more rapidly than ratably?" The principal on the loans will be amortized in the same manner as a mortgage. The interest benefit to the ratepayers will be recognized over the twenty-five year life of the loan, but appears to provide a larger benefit than the benefit generated when the unamortized ITCs are used to reduce rate base. On the other hand, the same amount of interest is used each year to determine the rental payment to TPS Generation.

The second issue is whether the interest charged TPS Generation by AEP Ohio is at the appropriate rates. In this transaction, the lease payment is based upon the weighted average cost of capital (WACC) of TPS Generation. TPS Generation's WACC takes into account, among other items, the interest rate charged by AEP Ohio to TPS Generation on these loans. Generally, in the computation of the revenue requirement on rate base, the pre-tax rate of return is the utility's WACC. The

[2] The same provision has been in the last three versions of these regulations.

reduction in the nonbypassable charge by the interest earned by AEP Ohio on the loans would appear to be similar to the benefit generated by a reduction in rate base from the amortized ITC but for the benefit being computed by using an interest rate that differs from AEP Ohio's WACC.

Q. COULD THE PROPOSED TREATMENT OF ACCUMULATED DEFERRED INCOME TAXES CREATE A NORMALIZATION VIOLATION?

A. The proposed reduction in the nonbypassable charge for the benefits of accumulated deferred income taxes appears to follow the same treatment that would have been used in computing the revenue requirement based upon a reduction in rate base for accumulated deferred income taxes. Therefore, it would not appear to create a normalization violation.

Q. DO YOU HAVE NORMALIZATION CONCERNS AS TO THE COMPUTATION OF THE LEASE PAYMENTS? IF SO, PLEASE DISCUSS.

A. Yes. As stated above, the §1.46-6 regulations do not allow a utility to avoid the normalization requirements by doing indirectly that which it could not do directly. AEP Ohio must clarify with the IRS that lease payments based upon the WACC of TPS Generation does not somehow do indirectly that which AEP Ohio could not do directly.

A large share of TPS Generation's capital structure is low cost debt and its WACC is less than that of AEP Ohio. AEP Ohio's investment in TPS Generation is designed to produce an after-tax rate of return to AEP Ohio equal to the after-tax rate of return that AEP Ohio should earn on its investment in rate base. Thus, it would appear that, but for the insertion of TPS Generation as AEP Ohio's means to invest in a solar project and but for TPS Generation's capital structure, if AEP Ohio had the same capital structure, there would be no normalization issues.

Q. HOW DOES AEP OHIO PROPOSE TO BRING CLARITY TO ITS POSITION THAT THE PROPOSED TRANSACTION WILL NOT BE IN VIOLATION OF THE NORMALIZATION REQUIREMENT?

A. AEP Ohio will ask for a letter ruling from the IRS that confirms that the non-traditional ratemaking that AEP Ohio proposes in this proceeding is consistent with the normalization rules.

Q. HAVE YOU ALREADY CONTACTED THE IRS CONCERNING THESE ISSUES?

A. Yes. On April 6, 2011, I and other representatives of AEP Ohio participated in a pre-filing conference with representatives of the IRS Office of Chief Counsel in the IRS National Office in Washington, D.C.

Q. WHAT WAS THE RESULT OF THE PRE-FILING CONFERENCE?

A. After a thorough discussion of the issues, the IRS Associate Chief Counsel commented that under IRS ruling procedures, the IRS will not rule on a hypothetical transaction. In particular, with respect to normalization issues, an IRS ruling will be issued only in response to a Commission-endorsed proposal.

Q. WHAT ARE THE NEXT STEPS IN ACQUIRING A LETTER RULING?

A. AEP Ohio will wait for an order or other action from the Commission that will allow us to file a ruling request with the IRS.

Q. DO ANY PHASES OF THIS PROJECT QUALIFY FOR BONUS DEPRECIATION?

A. No. The planned placed in service dates are after 2012 and are outside the current bonus depreciation provisions pursuant to §168(k). Additionally, solar property is not property having longer production periods treated as qualified property pursuant to §168(k)(2)(B) wherein, if placed in service in 2013, pre-2013 costs would qualify for bonus depreciation.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.

CERTIFICATE OF SERVICE

The undersigned hereby certifies that a true and correct copy of the foregoing Supplemental Direct Testimony of Michael J. Kelley on behalf of Columbus Southern Power Company and Ohio Power Company has been served upon the below-named counsel via First Class mail, postage prepaid, this 1st day of July, 2011.

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