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BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application of Columbus Southern Power Company and Ohio Power Company, Individually and, if Their Proposed Merger is Approved, as a Merged Company (collectively, AEP Ohio) for an Increase in Electric Distribution Rates	)	Case No. 11-351-EL-AIR Case No. 11-352-EL-AIR
In the Matter of the Application of Columbus Southern Power Company and Ohio Power Company, Individually and, if Their Proposed Merger is Approved, as a Merged Company (collectively, AEP Ohio) for Tariff Approval.	)	Case No. 11-353-EL-ATA Case No. 11-354-EL-ATA
In the Matter of the Application of Columbus Southern Power Company and Ohio Power Company, Individually and, if Their Proposed Merger is Approved, as a Merged Company (collectively, AEP Ohio) for Approval to Change Accounting Methods.	)	Case No. 11-356-EL-AAM Case No. 11-358-EL-AAM

DIRECT TESTIMONY OF J. EDWARD HESS
ON BEHALF OF INDUSTRIAL ENERGY USERS-OHIO

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I. INTRODUCTION

Q1. Please state your name and business address.

A1. J. Edward Hess, 21 East State Street, 17th Floor, Columbus, Ohio 43215.

Q2. By whom are you employed and in what position?

A2. I am employed as a Technical Specialist by McNees Wallace and Nurick LLC ("McNees"). I am providing testimony on behalf of the Industrial Energy

Users-Ohio ("IEU-Ohio"). IEU-Ohio is an association of commercial and industrial customers and functions to address issues that affect the price and availability of energy they need to operate their Ohio plants and facilities.

Q3. Please describe your educational background.

A3. I received a Bachelors of Business Administration degree from Ohio University in 1975 majoring in accounting. I completed the majority of Capital University's Master of Business Administration program and I have completed many regulatory training programs. I am a certified public accountant in accordance with Ohio certification requirements.

Q4. Please describe your professional experience.

A4. I have been employed by McNees since October 2009. In March 2009, I retired from the Public Utilities Commission of Ohio ("Commission") after 30 years of employment. Prior to my retirement from the Commission, I was the Chief of the Accounting and Electricity Division of the Utilities Department. My duties included ensuring statutory compliance with state and federal laws, rules, regulations, and procedures governing utility regulation with the majority of that responsibility in the electric industry. I was also responsible for auditing and reporting on the operating income and rate base components of the ratemaking formula under Section 4909.15, Revised Code, and general accounting matters for all public utility sectors subject to the Commission's ratemaking jurisdiction.

Q5. Have you previously submitted expert testimony before the Commission?

A5. I have testified numerous times before this Commission, beginning in the early 1980's, as part of my responsibilities as a Commission employee and since joining McNees.

Q6. What is the purpose of your testimony in these proceedings?

A6. My testimony addresses several issues IEU-Ohio framed by objections to the Staff Reports of Investigation ("Staff Report"), including issues associated with the distribution investment rider ("Rider DIR"), the distribution asset recovery rider ("Rider DARR"), factored customer accounts receivable, the amortization period of the over-accrued depreciation reserve, the distribution of revenue responsibility between and within rate groups and provider of last resort ("POLR") revenues.

Q7. What are your recommendations on the issues you are addressing in your testimony?

A7. My recommendations can be summarized as follows:

- For Rider DIR, I recommend that the Commission consider and address the conflicts, unjustness and unreasonableness created by contemporaneous proposals to establish DIR mechanisms in the Stipulation and Recommendation under consideration in Columbus Southern Power Company's ("CSP") and Ohio Power Company's ("OP") (collectively "the Companies") electric security plan ("ESP") cases (Case Nos.

11-346-EL-SSO, *et al.*)[1] ("ESP Stipulation") and the Staff Reports submitted in these proceedings. If the DIR mechanism in the ESP Stipulation is approved as proposed and the rate base valuation recommended in the Staff Reports is adopted, the combined ESP and rate case rates and charges will double allow, among other things, the Companies to collect rates and charges including a return on and of net plant investment, and thereby produce unreasonable and unjust rates. To cure this problem, I am recommending a means of synchronizing the results of the Commission's rulings regarding the various DIR mechanisms with CSP's and OP's base distribution rates so as to avoid double recovery of costs and unreasonable rates.

- For Rider DARR, I recommend that the interest rate applicable to the unrecovered regulatory asset balance during the recovery period be based on a reasonable and current debt interest rate established at the time amortization commences and that OP and CSP be required to demonstrate that the interest rate is prudent relative to the options that I believe OP and CSP should explore as part of their obligation as public utilities. Because the net effect of my recommendations (when applied to the Staff Reports) would reduce the Companies' authorized distribution revenue relative to revenue requested, I also recommend the amortization period commence coincident with the effective date of any new rates approved in these proceedings, rather than on January 1, 2013, subject to an audit and verification by the

[1] *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 Nos. 11-346-EL-SSO, *et al.*, Application (January 27, 2011) (hereinafter referred to as "ESP Cases").

Commission's Staff ("Staff") of the regulatory asset balance, and any necessary reconciliations stemming from such audit and verification process. The distribution rates which are warranted in these cases provide an opportunity to accelerate the amortization and thereby reduce the interest charge over the term of the amortization period. Additionally, I recommend that the approved interest rate be applied to the regulatory asset balance net of accumulated deferred income taxes ("ADIT") that built up during the regulatory asset accrual period and will continue during the amortization period. The Staff Reports did not address the ADIT adjustment but this adjustment must be made in accordance with proper ratemaking practices and to produce just and reasonable rates.

- I recommend that the test year adjustment associated with factoring (or selling) of accounts receivable be excluded from test year operation and maintenance ("O&M") expenses. The Staff Report for CSP includes a factoring adjustment of $11.9 million during the test year and the OP Staff Report includes a factoring adjustment of $10.3 million during the test year. Both adjustments have the effect of artificially reducing net operating income at current rates. It is unreasonable to make this factoring adjustment for rate-making purposes.

- I also recommend that the annual depreciation expense amount used to establish the annual revenue requirement for CSP and OP be reduced by amortizing the portion of the depreciation reserve that is over-accrued or excessive, using a seven-year amortization period rather than the 15 years proposed in the Staff Reports.

- With regard to distributing the authorized revenue to the various rate schedules, I support alignment between such revenue responsibility and the results of the fully allocated cost of service studies. In the case of the OP revenue distribution, I explain that the Staff Report's failure to align such revenue responsibility with the cost of service is unwarranted in view of the Staff Report's revenue requirement recommendation and particularly unwarranted if, as I recommend, the distribution revenue requirement is reduced thereby reducing rates. Smaller rate increases than recommended in the Staff Reports or a decrease in rates provide a useful opportunity to bring distribution rates in line with the identified cost of providing distribution service.

- Finally, I recommend that the Commission recognize the POLR revenues collected during the test year as a distribution service component and that these revenues be included in the operating income calculation for current rates. These revenues were authorized by the Commission to compensate the Companies for distribution-related functions.

My findings and recommendations are discussed in greater detail in the remainder of my testimony.

Q8. What did you review for purposes of preparing your testimony?

A8. For the purpose of preparing my testimony, I reviewed portions of the applications and direct testimony in these cases, discovery responses related to the areas covered by my testimony, the Staff Reports, and Commission entries filed in these cases. In addition, I reviewed portions of the testimony that have been filed in the Companies' ESP Cases where such testimony touched upon issues I address in my testimony. I also reviewed AEP's 2010 10-K, pages 129-130. My recommendations also reflect the knowledge I have accumulated throughout my career.

II. DISTRIBUTION INVESTMENT RIDER

Q9. What DIR mechanism did the Companies propose in the distribution rate cases?

A9. Before discussing the discrete DIR mechanisms proposed in the rate cases ("Rate Case DIR"), I think it may be helpful to discuss the bigger picture created by the Companies' applications to increase distribution rates. In their rate increase applications, the Companies are asserting that current distribution revenues do not provide them with an opportunity to obtain adequate compensation based on the costs of providing service which are eligible for recovery in accordance with Ohio's ratemaking formula, Commission precedent and other principles and practices that may affect the determination of the costs eligible for recovery. Thus, the rate increase applications themselves are really applications to recover costs related to distribution service. These costs would include items like distribution investment and the return on and return of (depreciation expense) components of the ratemaking formula. The rate increase applications also are designed to match annual distribution revenues that the Companies are authorized to collect with expenses that are eligible for recovery through rates. The expenses eligible for recovery include, among other things, local, state and federal taxes and O&M expenses. The results of the distribution rate cases will pick up all the allowable costs of providing service plus provide a reasonable return based on the test year and date certain parameters that are part of Ohio's ratemaking formula.

Thus, any consideration of the proposals to establish discrete DIR mechanisms must begin with the understanding that the Companies' applications for rate increases will provide the Companies with an opportunity to collect revenues to pick up all the allowable costs associated with providing distribution service, including a return on and of the net plant in service included in rate base as of the date certain plus all taxes and O&M expenses associated with such investments that are identified within the test year parameters. Once new distribution rates are set based on Ohio's ratemaking process, the revenue which the Companies are authorized to collect will provide the Companies with an opportunity to recover all the costs eligible for recovery from distribution service customers.

As stated above, it is important to appreciate that the Ohio ratemaking process as applied to distribution service is also a means by which the Companies recover all the categories and the level of costs that are picked up in the date certain rate base valuation and test year expenses. Once the function of the distribution rate case is appreciated, it then becomes easier to appreciate how discrete riders such as the proposed Rate Case DIR may unreasonably duplicate the compensation provided by the base distribution rates and charges. As in this situation, additional complications can set in when the Companies are proposing another discrete recovery mechanism substantially similar to the Rate Case DIR in another case such as an ESP case.

In general, the problems I identify and explain in my testimony relative to the DIR mechanisms are problems that exist because the Companies and the Staff Reports have ignored the interrelationships between the distribution rate cases, the Rate Case DIR and the DIR mechanism that may emerge from the ESP Cases, and are advancing recommendations that will produce distribution base rates and discrete DIR mechanisms that double count costs eligible for inclusion in distribution service rates and charges.

Now, I will describe the proposed Rate Case DIR.

The Rate Case DIR mechanism proposed in the rate cases is addressed in the pre-filed written testimony of Companies' witnesses Moore and Kirkpatrick. Companies' witness Moore indicated that the Rate Case DIR would, if approved, allow the Companies to increase rates and charges so as to recover, among other things, a carrying charge on certain distribution plant. The "carrying charge" computation as proposed by the Companies produces a carrying charge that includes a broad category of costs and should not be confused with the portion of the traditional ratemaking formula that provides for a return <u>on</u> investment or rate base. For example, the Companies' proposed carrying charge would be calculated each year using a pre-tax weighted average cost of capital ("WACC") and include an O&M expense component adder equal to 3.5% of the net plant balance. The Companies have historically calculated WACC to include the tax deductibility of debt and the taxability of both the debt and the equity components. The Companies proposed to update the Rate Case DIR quarterly in 2012 but their rate increase applications do not address the updating process beyond 2012. The distribution plant balance used for the Rate Case DIR would be derived from Federal Energy Regulatory Commission ("FERC") Form 3Q, which is filed quarterly with FERC. The Rate Case DIR would be subject to reconciliation for under and over recovery and would be collected as a percentage of base distribution revenues.

The reconciliation aspect of this proposal effectively turns the Rate Case DIR mechanism into a guarantee that the Companies will recover amounts eligible for recovery through the Rate Case DIR rather than providing the Companies with an opportunity to recover such amounts. Under traditional ratemaking principles, utilities are provided with a reasonable opportunity to earn a reasonable return on capital investment used and useful in the rendition of public utility service and do not receive a recovery guarantee.

The Staff Reports for CSP and OP recommend that the Companies' Rate Case DIR be considered in the ESP Cases and that the Commission should not, in any event, use the net plant levels in 2000 as the investment baseline for a DIR mechanism until a decision is rendered in these distribution rate cases.

Approval of another discrete DIR mechanism ("ESP DIR") has been recommended as an element of the ESP Stipulation referenced above in my testimony.

Q10. Please describe the proposed ESP DIR contained in the ESP Stipulation.

A10. The ESP Stipulation, in Section IV(1)(n), beginning on page 8, recommends that the Commission approve a non-bypassable DIR to be effective January 1, 2012. The proposed ESP DIR would authorize significant revenue increases and reach back to post-2000 investment to set the baseline for purposes of computing the amount of the ESP DIR rate and revenue increases. The recommended carrying charge component of the ESP DIR includes elements for property taxes, commercial activity taxes, associated income taxes and a return "on" and "of" plant in service resulting from distribution net investment associated with distribution plant recorded in FERC Accounts 360-374. The post-2000 net additions that drive the ESP DIR revenue increases reflect gross plant in service amounts adjusted for growth in accumulated depreciation. The ESP DIR's revenues to be collected include a WACC return on post-2000 net capital additions that is based on a cost of debt of 5.34%, a cost of preferred stock of 4.40%, and a return on equity of 10.5% (utilizing a capital structure consisting of

47.06% debt, 0.19% preferred stock, and 52.75% common equity). The ESP DIR revenue requirement is capped at $86 million in 2012, $104 million in 2013, and $124 million in 2014; and the rider will terminate on May 31, 2015. Based on information provided by CSP and OP, it is my understanding that the Companies expect the ESP DIR rate increase in 2012 to reach the $86 million cap.

Q11. Is IEU-Ohio a signatory to the ESP Stipulation?

A11. No. IEU-Ohio did not sign the Stipulation.

Q12. Do you believe that the ESP DIR is reasonable?

A12. No. IEU-Ohio submitted testimony in the ESP Cases that demonstrates that the ESP DIR proposal is neither reasonable nor lawful. But, if the Commission nonetheless approves the ESP DIR or the Rate Case DIR, which is also unreasonable as proposed, then the effects of the cost recovery provided by base distribution rates and charges set in these rate cases must be recognized in specifying the costs included in the DIR mechanisms and the baseline used to compute the level of any incremental rate increases that may occur through a DIR mechanism.

Q13. Why is it necessary to address the ESP DIR for purposes of authorizing the level of distribution service revenues the Companies should be authorized to collect as a result of the distribution rate cases?

A13. The post-2000 baseline used for the ESP DIR and the Staff Reports' recommended date certain (August 31, 2010) valuation of plant in service in these rate cases could operate to create two means for the Companies to recover distribution-related costs and in combination thereby provide the Companies with duplicate recovery of the same costs. The Staff Reports' use of a rate base valuation as of August 31, 2010 includes the net valuation of all distribution plant included in rate base as of the August 31, 2010 date certain. In other words, the Staff Reports' rate base valuation dollar amount includes the post-2000 investment that is the focus of the ESP DIR. The Staff Reports' test year O&M expenses also include all expense levels, including property taxes, commercial activity taxes, associated income taxes and depreciation expense (return of investment) associated with the date certain plant valuation (including the post-2000 investment) within the test year parameters used for ratemaking purposes. The gross revenue conversion factor used in the Staff Reports to calculate the recommended revenue requirement also includes allowances for taxes based on the statutory rates for such taxes as the federal income tax.

In summary, the ESP DIR would, if approved, result in rate increases to recover the same costs embedded in the Staff Reports' distribution service revenue requirement. Layering the ESP DIR or the Rate Case DIR on distribution rates that are established based on a date certain of August 31, 2010 and a test year ending May 31, 2011, results in providing the Companies with an opportunity for a guarantee of double cost recovery and produces unjust and unreasonable distribution rates.

Q14. Did the Staff Reports identify and address the potential for "double dipping" rate increases which you regard as unreasonable?

A14. The Staff Reports appear to recognize the double recovery problem by suggesting that the post-2000 investment baseline should not be used but the Staff Reports failed to recommend a means to synchronize the results in the ESP Cases and the disposition of the Companies' proposed Rate Case DIR with the results in the distribution rate cases, thereby leaving customers exposed to the unreasonable double recovery consequence that I have discussed. If the proposed ESP DIR or Rate Case DIR is approved, in whole or in part by the Commission, the approved DIR mechanism must recognize the cost recovery that is taking place through the distribution rates set in the rate cases to ensure that the Companies' rates and charges are not based on double counting the same plant investment and expenses that are embedded in distribution rates in accordance with the ratemaking formula described in the Staff Reports.

Q15. Are there other gaps created by the lack of synchronization between the CSP and OP Staff Reports and the discrete DIR mechanism proposals?

A15. Yes. The rate of return range recommended in the Staff Reports is based on a finding that a reasonable return on common equity is 8.6% to 9.6%. The return on equity component of the proposed ESP DIR is 10.5%. This 10.5% amount is unaccompanied by any cost of equity capital evidence provided in the ESP Cases. Regardless of this inconsistency, a return on common equity of 10.5% is unreasonable based on current cost of capital considerations and the proposed discrete DIR recovery mechanisms lower the Companies' business and financial risk. In circumstances where rate mechanisms work to reduce going forward business or financial risk, the Commission has reduced the return on common equity. For example, in *In the Matter of the Application of Vectren Energy Delivery of Ohio, Inc. for Authority to Amend Its Filed Tariffs to Increase the Rates and Charges for Gas Service and Related Matters*, Case Nos. 07-1080-GA-AIR, *et al.*, Opinion and Order at 6 (January 7, 2009), the Commission approved a 25 basis point reduction to the common equity return to reflect the risk-reducing effect of the rate design approved by the Commission. The DIR mechanism guarantees cost recovery rather than providing an opportunity for recovery and it lowers the Companies' business and financial risk relative to the risks that would otherwise exist.

Q16 Should the proposed DIR mechanisms contain an increase for O&M expenses?

A16. No. As older distribution plant is replaced with newer facilities, the level of O&M expense should decline relative to the level reflected in current rates. Because all distribution-related O&M expense is included in the specification of new distribution rates through the rate case process and the O&M reflects distribution plant as of the date certain, any consideration of O&M expense for inclusion in a DIR mechanism should be confined to a determination of how much O&M expense should be **reduced** from the level included in the new distribution rates. Increasing O&M expense through a DIR mechanism is unreasonable in my view.

Q17. How do you recommend that the discrete DIR mechanisms – either the Rate Case DIR or the ESP DIR – be synchronized with the results of the Companies' distribution rate cases to avoid the double recovery and unreasonable rate outcomes you have discussed?

A17. To avoid the double recovery and unreasonable rate outcomes, I recommend that any discrete DIR mechanism approved by the Commission only apply to future net plant additions since the plant in service which the Commission adopts for purposes of establishing new distribution rates will pick up the date certain net rate base value for purposes of establishing distribution rates. I further recommend that any DIR mechanism adopted by the Commission be limited to return on and of components with the return on component based on the cost of capital adopted by the Commission in the rate cases (as adjusted to reflect the risk-reducing effect of a DIR mechanism).

III. DISTRIBUTION ASSET RECOVERY RIDER

Q18. What did the Companies propose with respect to Rider DARR?

A18. CSP and OP have proposed to establish a charge to amortize certain deferred costs that have been approved in various proceedings and are presently reflected in regulatory asset balances. The proposed charge would amortize these regulatory asset balances over a seven-year period and the amount amortized would include a full WACC carrying charge that accounts for the tax deductibility of the debt portion and the taxability of the debt and equity portion. Using the method proposed by the Companies, the carrying charge through the seven-year amortization period is approximately 12.89% for CSP and 13.86% for OP as shown on Companies' witness Mitchell's Exhibits TEM-4 and TEM-5. CSP and OP are both proposing that the recovery period begin with the first billing cycle in 2013. The list of regulatory asset categories and the cases in which the amounts were authorized to be deferred are described on page 13 of the OP Staff Report and on page 13 of the CSP Staff Report.

Q19. What did the Staff Reports recommend with respect to the Rider DARR proposal?

A19. The Staff Reports recommended that the Companies' requests be approved but recommended that the balances be reviewed prior to implementation of the rider, and that the carrying cost rate during the recovery period beginning January 1, 2013 be the most recent Commission-approved long-term cost of debt.

Q20. Are the Companies' proposed Rider DARR and the Staff Reports' modifications to the proposed Rider DARR reasonable?

A20. The Companies' proposed Rider DARR is not reasonable and I believe that the Staff Reports' modifications to the proposed Rider DARR could be reasonable if the Staff Reports' recommendation to use the most recent approved long-term cost of debt would have been more specific. I agree with the Staff Reports' recommendation that the carrying charge during the amortization period should be based on a debt cost and not based on a WACC calculation. With regard to the debt rate that should be used, I recommend that the Commission authorize a rate that would be in the low end of the range for seven-year, BBB rated, newly issued corporate bonds. Rates for these bonds are presently being issued at an interest rate of about 3.75%. There is no good reason for the carrying charge to be based on an interest rate that is not current. The rate should be annualized and include only the most recent cost. The use of current information is consistent with sound regulatory principles and practices. The use of the low end of the range is appropriate because Rider DARR is a self-reconciling amortization that presents the Companies with no recovery risk.

I also recommend that the rate be applied to a regulatory asset balance that is reduced for ADIT consistent with sound regulatory practices and principles. The deferrals associated with Rider DARR cause a timing difference between the tax deduction and the book accounting treatment. The timing difference reduces the Companies' federal income tax liability before the Companies recognize the expense and collect it from customers. This difference is accounted for on the Companies' balance sheets. To be fair to customers, that timing difference must be used to reduce the deferred balance to which the carrying charge rate is applied. In most cases, the ADIT would amount to approximately 35% of the regulatory asset balance. In summary, the ADIT represents tax savings and cost reductions realized by the Companies. As a result of these tax savings, the Companies are not financing 100% of the deferral, but only the deferral amount net of the ADIT, or approximately 65%. An adjustment to reflect the ADIT benefit obtained by the Companies is necessary to avoid an unreasonable Rider DARR.

Finally, because the net effect of my recommendations when applied to the Staff Reports results in lower rates than proposed by the Companies, I also recommend the Rider DARR amortization period commence coincident with the effective date of new rates approved in this proceeding, rather than on January 1, 2013 as proposed by the Companies. The lower revenue I recommend provides an opportunity to accelerate the amortization of the regulatory assets that are the target of Rider DARR and this acceleration will reduce the total cost that customers pay as a result of the amortization of the regulatory asset balances.

Q21. Has the Staff recommended a specific valuation for the Rider DARR regulatory assets?

A21. The Staff Reports recommended that the per-book regulatory asset balances be reviewed prior to implementation of the Rider. In addition to a review requirement, I recommend that the balances be verified to make sure that the carrying charges embedded in the regulatory asset balances have been properly calculated by applying the carrying charge rate to the deferred balance minus the ADIT as I described earlier in my testimony. If the carrying charges do not account for the necessary reduction for ADIT, the value of the regulatory assets subject to amortization through Rider DARR will be overstated and excessive when measured by proper ratemaking principles.

IV. FACTORED CUSTOMER ACCOUNTS RECEIVABLE

Q22. Did the Companies propose to reduce test year operating income by an amount that they classify as a "loss" attributed to factoring accounts receivable?

A22. Yes. In both CSP's and OP's applications, the test year operating income is reduced by a "loss" which the Companies attribute to factoring customer accounts receivable loss (charged to FERC Accounts 426.5009,10). The effect of this reduction to operating income is to understate test year operating income and overstate the revenue requirement. The loss is shown on page 2 of 5 of Schedule C-2.1 in both CSP's and OP's applications. The loss for CSP is $11.9 million and the loss for OP is $10.3 million.

Q23. Are these amounts embedded in the adjusted operating income recommended by the Staff Reports?

A23. Yes. The Staff Reports did not make an adjustment to exclude these losses from the computation of test year operating income.

Q24. Should these so-called losses be applied to reduce test year operating income?

A24. No. Operating income should not be reduced as a result of any losses that might be attributed to factoring accounts receivable. The operating income amounts proposed by OP and CSP and contained in the Staff Reports are too low by the amount of the loss adjustment associated with factoring. Any loss that might be associated with factoring receivables is a below-the-line item meaning that it is not eligible for explicit consideration in the ratemaking formula. Any loss associated with selling accounts receivable (factoring) should not be considered for purposes of computing the recommended revenue requirement. These losses arise from the sale of an asset (the accounts receivable) and are not properly an offset to operating income for ratemaking purposes. I should note that because of my view that any such adjustment to operating income is inappropriate, I did not identify the extent to which the Companies' and the Staff Reports' adjustments include receivables beyond distribution service receivables. If, contrary to my opinion, any adjustment to operating income is considered for this item, it would be unreasonable to calculate an adjustment based on anything more than distribution service receivables.

Q25. Will you briefly describe factoring of accounts receivable?

A25. Factoring, or accounts receivable factoring, involves selling the right to revenue associated with accounts receivable to another party. The value of the accounts receivable is discounted to reflect a present value and the party purchasing the revenue right provides an upfront cash payment to the party selling the revenue right at the discounted value for the right to receive the full value of the receivable when it is collected. The sale has historically been accounted for as a sale of an asset and the difference between the value of the accounts receivable and the cash received is booked as a loss and accounted for in FERC Account 426.5, Other Deductions. The Commission has historically not included these factoring "losses" in computing the revenue requirement for ratemaking purposes unless there is an associated offset or benefit recognized for ratemaking purposes.

Q26. Has the Commission included the "losses" in other cases?

A26. I believe that issue was first addressed in Ohio Edison Company's rate increase proceeding, Case No. 89-1001-EL-AIR.[2] The Commission included factoring of accounts receivable loss in the operating income calculation because there had been an offsetting adjustment to the rate base through the working capital computation. The working capital calculation was reduced by an adjustment to the lag days applied to revenues in the lead lag study and, in effect, recognizing the improved cash flow resulting from factoring the receivables. The adjustment to the lag days was a direct result of the factoring, or sale, of accounts receivable. The Staff recommended, and the Commission agreed, that since the working capital allowance had been adjusted (reduced) by recognition of the effects of factoring of accounts receivable, recognition of the factoring loss was appropriate.

To my knowledge, the Commission has applied this policy consistently since Case No. 89-1001-EL-AIR. The inclusion of the below-the-line cost in this instance is similar to the inclusion of below-the-line interest expense for customer deposits in the operating income calculation and the use of customer deposits as a reduction to the rate base through the working capital computation or otherwise. Interest cost is not properly includable in O&M expenses but since the customer deposits are applied for ratemaking purposes as a rate base deduction, the interest expense for customer deposits is included.

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[2] *In the Matter of the Application of Ohio Edison Company for Authority to Change Certain of its Filed Schedules Fixing Rates and Charges for Electric Service,* Case No. 89-1001-EL-AIR, Opinion and Order at 68 (August 17, 1990).i

Q27. Are there any other cases in which the Commission included factoring losses and an associated offset to rate base?

A27. Yes. The last CSP rate increase proceeding, Case No. 91-418-EL-AIR,[3] included a similar issue. The Commission included a $50 million rate base reduction in the working capital calculation and included an "expense" associated with the sale of accounts receivable.

Q28. As the Companies and the Staff Reports have treated the factoring "loss" in these cases, is there an offsetting reduction to the CSP or OP rate base as existed in the cases you just described?

A28. No offsetting reduction to the rate base was proposed by CSP, OP, or the Staff Reports related to the factoring of accounts receivable. Therefore, inclusion of this below-the-line "loss" adjustment to operating income is improper.

Q29. Have OP and CSP changed the accounting for factoring of accounts receivable?

A29. Yes, this change is described in the 2010 Form 10-K which is filed with the Securities and Exchange Commission ("SEC") at page 129. It is referred to as "Securitization Accounts Receivable – AEP Credit." A subsidiary of American Electric Power, AEP Credit, securitizes an interest in receivables it acquires from certain of its affiliates (including OP and CSP) to bank conduits and receives cash. New accounting guidelines require that these types of factoring transactions be accounted for as financings rather than sales of receivables.

[3] *In the Matter of the Application of Columbus Southern Power Company for Authority to Amend its Filed Tariffs to Increase the Rates and Charges for Electric Services*, Case No. 91-418-EL-AIR, Opinion and Order at 43-44 (May 12, 1992) and Staff Report of Investigation at 9 (November 13, 1991).

This accounting change was effective January 2010 or well within the test year. This accounting change also would result in the removal of the factoring loss adjustment to operating income because this accounting also shows that the factoring "loss" is a below-the-line item (not includable for ratemaking purposes).

Q30. How are the costs associated with financing reflected in the ratemaking process?

A30. Costs related to financing, including the financing of accounts receivable, are not properly includable in O&M expenses.

Allowable financing costs are properly included in the rate of return calculation. If the Commission believes that these costs should be accounted for in the revenue requirement calculation because of this accounting change, they should consider including them in the rate of return calculation and more specifically in the weighted cost of debt capital calculation.

Q31. What are you recommending?

A31. I am recommending that the Companies' and Staff Reports' reduction to operating income be removed to exclude the "loss" for factored customer accounts receivable. The adjustment would decrease operating expenses at current rates for CSP by $11.9 million and by $10.3 million for OP and increase the operating income by the net-of-tax value of the reduction.

V. AMORTIZATION PERIOD OF THE OVER-ACCRUED DEPRECIATION RESERVE

Q32. Please describe the Staff Reports' recommendations to correct for the over-accrual of the depreciation reserve.

A32. The Staff Reports compared both CSP's and OP's unadjusted, or booked, depreciation reserve to a calculated theoretical reserve as a guide to determine whether past depreciation accrual calculations and the accumulated depreciation expense contained in the depreciation reserve have produced an appropriate depreciation reserve. The Staff Reports find that CSP's and OP's booked depreciation reserves are excessive ("over-accrued'). The over-accrual calculated by the Staff Reports (the difference between the theoretical reserve and actual book reserve) is $179.2 million for CSP and $92.0 million for OP.[4] The Staff Reports recommended that the over-accrual be amortized over a 15-year period and then used the amortization of the over-accrual as an offset to the Staff Reports' recommended depreciation expense.

Q33. Do you agree with this recommendation?

A33. I agree that the over-accrual should be used as an offset to depreciation expense embedded in distribution rates, but I do not believe that it is reasonable to use a 15-year amortization period to compute the amount of the offset based on the facts and circumstances here. I believe that the amortization period for this over-accrual should be seven years. This is the same amortization period over which CSP and OP are requesting to amortize the regulatory assets subject to

[4] CSP Staff Report at 6; OP Staff Report at 6.

amortization through Rider DARR. Using the same seven-year amortization period that the Companies have proposed for Rider DARR for the amortization of the depreciation reserve over-accrual will help to reduce customers' electric bills relative to the use of a 15-year amortization period.

Q34. What is the impact of your recommendation to amortize the depreciation over-accrual over seven years?

A34. The test year depreciation expense recommended in the Staff Reports would be decreased by $13.65 million for CSP and by $7.01 million for OP.

VI. REVENUE DISTRIBUTION AND RATE DESIGN

Q35. Mr. Hess, please discuss the revenue distribution recommendations in the Staff Reports.

A35. The CSP Staff Report accepts the results of the fully allocated cost of service study submitted by the Companies and aligns revenue responsibility with the identified fully allocated cost of service. The OP Staff Report accepts the results of the fully allocated cost of service study but does not recommend distributing revenue to the OP rate schedules in accordance with the cost of service information based on concerns about the magnitude of the resulting increases. However, the amount of revenue assumed by the Staff Report in the revenue responsibility discussion is the amount of revenue which OP proposed, not the lower level recommended in the OP Staff Report or the lower level I recommend.

Q36. Do you believe the revenue distribution recommendation in the OP Staff Report is reasonable?

A36. No. Because the Staff Report recommends a lower level of revenue than OP requested, the Staff Report has overstated the need for "gradualism" or deviation from the results of the fully allocated cost of service study. Based on the OP revenue requirement recommended in the Staff Report, revenue distribution can and should be more aggressively aligned with the identified cost of service. To the extent that the Commission finds that OP's rates should be less than the amount OP has requested as I recommend, then the revenue distribution can and should proceed based on the cost of service results without any limitations that might otherwise be imposed based on the principle of gradualism. In view of the current emphasis on maintaining and growing Ohio's manufacturing sector, I believe it is important to promptly remove the distribution-related revenue that is currently embedded in the rates that apply to customers that receive electric service at the higher voltage levels. I also recommend that the structure of any DIR mechanism that the Commission may approve respect the results of the fully allocated cost of service study. Once distribution rates are aligned with the cost of service results, a DIR mechanism that establishes a charge based on a uniform percentage applied to base distribution revenue by rate schedule will help to maintain total distribution revenue responsibility that is aligned with the cost of service providing distribution service.

VII. PROVIDER OF LAST RESORT REVENUES

Q37. Do the Staff Reports reflect the POLR revenues in the operating income calculation?

A37. No. During the test year, CSP collected $95.8 million of distribution revenues during the test year and OP collected $53.1 million of distribution revenues during the test year. The Staff Reports do not include these revenues in the operating income calculations.

Q38. Should these revenues be included in the operating income calculations?

A38. Yes. These revenues were provided to the Companies to compensate the distribution companies for providing POLR service.

A39. What are you recommending?

A39. I am recommending that $95.8 million be included in the operating revenues for CSP and that $53.1 million be included in the operating revenues of OP based on the actual results during the test year. This increase in operating revenue should then flow through the other ratemaking formula steps to restate the resulting test year operating income.

Q40. Does this conclude your direct testimony?

A40. Subject to modifications that I may need to make as a result of changes in the Staff Reports, yes.

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing *Direct Testimony of J. Edward Hess on Behalf of Industrial Energy Users-Ohio* was served upon the parties of record this 24th day of October 2011 *via* electronic transmission, hand-delivery, or ordinary U.S. mail, postage prepaid.

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