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BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

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In the Matter of the Application of Columbus Southern Power Company and Ohio Power Company for Administration of the Signatory Excessive Earnings Test Under Section 4928.143(F), Revised Code, and Rule 4901:1-35-10, Ohio Administrative Code	)))))))	Case No. 11-4571-EL-UNC Case No. 11-4572-EL-UNC

INITIAL BRIEF OF COLUMBUS SOUTHERN POWER COMPANY AND OHIO POWER COMPANY

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INTRODUCTION

Section 4928.143(F), Revised Code, offers virtually no guidance as to its proper application, it is barren of any practical meaning, violates the void-for-vagueness doctrine, and is unenforceable. The terms used to describe the "significantly excessive earnings" test ("SEET") are very broad and general. No definitions, standards or guidance is provided to give the electric distribution utilities ("EDUs") fair notice of their risk of forfeiture or to give the Commission adequate standards to appropriately judge the result. Given the harsh, asymmetrical consequences leveled by a finding of significantly excessive earnings, and the burden on the EDUs 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, as a result, the statute is unconstitutionally vague.

Columbus Southern Power ("CSP") and the Ohio Power Company ("OPCo") (collectively, the "Companies") retained Dr. Anil K. Makhija to present a methodology that would give reasonable meaning to the SEET, while conforming to the language of the statute. Dr. Makhija's methodology for establishing an appropriate 2010 return on equity threshold for the SEET applicable to CSP and OPCo follows the methodology developed in the Companies' prior (2009) SEET proceeding and 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 Peer Group as normal earnings on average common equity, he obtained that group's mean earned return on equity ("ROE"), which is 11.48%.

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 2010 should be compared. Dr. Makhija concluded 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. Dr. Makhija also provided the calculation of the SEET Threshold that would result in the event the Commission were to apply the same 60% adder that it determined was appropriate as part of the Companies' 2009 SEET review.

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 in two respects. First, OSS net margins (after federal and state income tax) are deducted from the net earnings available to common shareholders (the numerator of the ROE) and from the equity base (the denominator of the ROE). This first adjustment conforms with the result the Commission reached in the 2009 SEET proceeding. The second adjustment that the Companies make to their earned ROEs is to remove the impacts of non-recurring costs of an organizational restructuring program, a change in the Medicare Part D subsidy, and to make a special adjustment that reflects earning subject to being returned to customers as a result of the 2009 SEET review.

Since OPCo's 2010 earned ROE of 9.88% is less than the safe harbor limit suggested by any of the witnesses in this proceeding, OPCo's 2010 earned ROE should not be subject to further SEET analysis. CSP's 2010 earnings are not above the appropriate 2010 SEET ROE Threshold and the Commission should not make a finding that significantly excessive earnings existed for CSP in 2010. Based on Dr. Makhija's ROE threshold recommendation of 22.61% (or even based on the 60% adder that the Commission adopted in the 2009 SEET proceeding, which would produce an 18.37% SEET ROE Threshold for 2010), there are no significantly excessive earnings based on CSP's adjusted earned ROE of 17.54%.

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 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 $1.6 billion capital investment in Ohio during the ESP. Specifically, even beyond the substantial level of "normal" investment committed by CSP (totaling 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, in the event it is necessary, to avoid a finding of significantly excessive earnings for CSP in 2010.

BACKGROUND

There are three basic steps to begin applying the SEET to CSP and OPCo for 2010. First, CSP's and OPCo's earned ROEs for purposes of the 2010 SEET must be determined. Second, the average earned ROE during 2010 by publicly traded firms with business and financial risks comparable to those that CSP and OPCo face must be calculated. Third, 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. Once those calculations are made, a comparison can be made between the SEET benchmark and CSP's and OPCo's earned ROE for the 2010 SEET. For the Companies' 2010 SEET filing, Companies witness Mitchell performed the calculations to support Companies witness Hamrock's application of the third step in his testimony and Companies witness Dr. Makhija performed steps two and three in his testimony.

As further discussed below, the results from these three initial steps are used to further evaluate whether significantly excessive 2010 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 in Case No. 09-786-EL-UNC 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 July 29, 2011, 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 2010 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.

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."

The Companies acknowledge that the Commission lacks authority to declare a statute unconstitutional. *Consumers' Counsel v. Pub. Util. Comm.* (1994), 70 Ohio St.3d 244, 247, 638 N.E.2d 550. They also acknowledge that the constitutionality of R.C. 4928.143(F) is now pending before the Ohio Supreme Court in Case No. 2011-0751, as a result of the cross-appeal filed by CSP in response to the Commission's decision in its prior SEET proceeding, *In the Matter of the Application of Columbus Southern Power Company and Ohio Power For Administration of the Significantly Excessive Earnings Test Under Section 4828.143(F), Revised Code, and Rule 4901-35-10, Ohio Administrative Code,* Case No. 10-1261-EL-UNC ("*SEET I*"). It is proper and necessary that the Companies re-assert the constitutional challenge to the statute in this second SEET proceeding, however, because it is highly unlikely that the Ohio Supreme Court will have resolved this issue prior to the Commission's decision in this proceeding.

R.C. 4928.143(F) is unconstitutionally vague in that it fails to give fair notice to Ohio EDUs as to what the law requires and likewise fails to provide standards to guide the Commission's discretion in enforcing the law. *Columbia, Natural Resources, Inc. v. Tatum*, 58 F.3d 1101, 1104 (6th Cir. 1995). Under the void-for-vagueness doctrine, a statute is unconstitutional if it is "so vague that men of common intelligence must necessarily guess as to its meaning and differ as to its application," *id.* at 1105 (citing *Connally v. General Constr. Co.*, 269 U.S. 385, 391, 46 S.Ct. 126, 70 L.Ed. 322 (1926)), or if it involves "so many factors of varying effect that neither the person to decide in advance nor the [decision-maker] 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)).

The Ohio Supreme Court explains and applies the void-for-vagueness doctrine in *Norwood v. Horney*, 110 Ohio St.3d 353, 2006-Ohio-3799. In that case, 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 held the ordinance unconstitutional even though it 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.

Like the eminent domain ordinance in *Norwood v. Horney*, R.C. 4928.143(F) results in the taking of property. 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, the statute clearly falls subject to the constitutional requirement that it give advance fair notice of what is required and ensure against arbitrariness in its application. As well illustrated by the Commission's prior attempts to divine the meaning of the SEET and the record in this case, R.C. 4928.143(F) cannot withstand constitutional 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 the Commission itself recognized early on, "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 statute, 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.

The Commission is now attempting to understand and apply the SEET for the fourth time, after having had little success in finding any common ground as to its meaning in the Companies' 2009 ESP case, or in the Commission's special investigation in 2010, *In the Matter of the Investigation into the Development of the Significantly Excessive Earnings Test Pursuant to Amended Substitute S.B. 221 for Electric Utilities*, Case No. 09-786-El-UNC, Finding and Order (June 30, 2010), or in *SEET I*, the decision currently on appeal. Time has not cured the deficiencies in the SEET as evidenced by the conflicting positions in this case.

Most telling of all, however, is the Staff's continued inability to give a cogent explanation for its own position as to the SEET. The Staff's position in this case aptly demonstrates the error in the Commission's conclusion in *SEET I* (at 10) that the statute "provides a clear benchmark for identifying 'excessive earnings.'" Staff witness Buckley, for example, candidly and appropriately acknowledged that while the Commission has noted several factors that can and should be considered in establishing the threshold return on equity, the Staff had not and could not consider those factors in reaching its conclusion and was forced to give only a "baseline" number, knowing that the Commission would then adjust the baseline up or down in its discretion. (Tr. v. I at 133-34.) When asked about the Commission's statement in *SEET I* at 25 that "on a going forward basis the Commission expects to refine the quantitative analysis associated with these factors through future SEET proceedings," Staff witness Buckley responded: "I don't have a real clear understanding of what they want going forward with that sentence." (Tr. v. I at 137.) He also explained the reason for the change in the Staff's own methodology from that in *SEET I* by stating he "was not comfortable using that method" and "wanted to use something that was more scientific and more – had more transparency." (Tr. v. I at 140.)

The Companies do not mean to criticize the Staff in this regard because the fault lies not with the Staff; the fault lies with the statute itself. The statute should have disclosed in advance the factors the Commission is to consider. The statute should have provided a clear understanding of what is expected and provided for sufficient transparency in its application. The Staff, the EDUs, and the other stakeholders should not have been left to "guess as to its meaning and differ as to its application" as they have now done in four separate proceedings. Because the SEET statute offers virtually no guidance as to its proper application, it is barren of any practical meaning and violates the void-for-vagueness doctrine.

II. CSP's and OPCo's Earned Return on Equity for 2010.

Companies witness Mitchell addressed the appropriate method for calculating earned ROE for both CSP and OPCo for the year ended December 31, 2010. He then provided his calculations of the Companies' earned ROEs for 2010 to Mr. Hamrock, who then used the earned ROEs to make the comparison with the 2010 SEET ROE Threshold. (Cos. Ex. 2. at 5-11 & Ex. TEM-1.)

Mr. Mitchell performed the calculation of the ROEs in two steps. First, he calculated the respective per books (unadjusted) 2010 ROEs for both CSP and OPCo, using the amounts for 2010 net earnings available to common shareholders compared to the average of the beginning and ending equity for the year ended December 31, 2010. (*Id.* at 5 & Ex. TEM-1 at 1.) The Commission has previously determined that use of the average of beginning and ending equity is appropriate in its August 25, 2010 Entry on Rehearing (at 6) in Case No. 09-786-EL-UNC and in its Opinion and Order (at 21-23) in Case No. 10-1261-EL-UNC. Use of the average equity calculated in this manner is also consistent with the calculation of the average equity that Dr. Makhija used in connection with his development of a comparable risk peer group.

In the second step of his calculation, in accordance with the Commission's decision in Case No. 10-1261-EL-UNC, Mr. Mitchell made adjustments (after federal and state income taxes) to remove the OSS net margins, as well as three non-recurring and special items, from the net earnings available to common shareholders (i.e., from the numerator of the ROE) and from common shareholder equity (i.e., from the denominator of the ROE). The three non-OSS related adjustments, which were also made in order to remove the impact of non-recurring and special items from the ROE calculation, reflected organizational restructuring charges, a change in the Medicare Part D subsidy, and the results of the 2009 SEET review. (There was no minority interest, nor any extraordinary items during 2010, for either CSP or OPCo, so no adjustments were necessary for such items.) (Cos. Ex. 2 at 5.)

Mr. Mitchell took the net amount of all four adjustments, as shown on page 1 of Ex. TEM-1 to Cos. Ex. 2, for the twelve months ended December 31, 2010 and removed their impact on earnings. For each adjustment to the numerator of the ROE calculation a related adjustment also was made to the denominator, consistent with the Commission's order in *SEET I*, Case No. 10-1261-EL-UNC. For all adjustments except OSS net margins, the Companies used the same after-tax amount calculated for the numerator to adjust the denominator. (Cos. Ex. 2 at 6-7.)

A. Adjustment To Exclude Off-System Sales Margins.

As noted above, in accordance with the Commission's orders in Case No. 10-1261-EL-UNC, Mr. Mitchell made an adjustment (after federal and state income tax) to remove the OSS net margins from the net earnings available to common shareholders, i.e., from the numerator of the ROE calculation. In compliance with the Commission's directive that adjustments made to the numerator should also have related adjustments in the denominator, the Companies also made an adjustment to the equity base, which is the ROE's denominator. In order to make this adjustment to the ROE denominator, Mr. Mitchell compared the Megawatt hours (MWh) sold for OSS to the MWh generated by those plants, as shown on page 5 of Exhibit TEM-1 to Cos. Ex. 2. Mr. Mitchell then multiplied this MWh ratio by the amount of equity related to generation plant net book value (NBV), as shown on page 4 of Exhibit TEM-1.

While similar, the approach that Mr. Mitchell used to calculate the OSS adjustment to the denominator is not precisely the same as the one employed by the Commission in the previous 2009 SEET review in Case No. 10-1261-EL-UNC, but according to Mr. Mitchell it is an improvement. The method used in the prior SEET case used total sales for resale as a percentage of total sales to ratio the equity related to generation plant NBV. Mr. Mitchell explained that the total sales for resale includes affiliated sales for resale and Transmission Cost Recovery Rider (TCRR) transactions, which are not related to OSS net margins, and that including them in the ratio would distort the allocation, particularly for OPCo. Consequently, Mr. Mitchell recommended using a method that is more directly related to OSS net margins because it uses the actual output of OSS MWh to ratio the amount of equity related to generation plant NBV. Mr. Mitchell's approach results in a reduction to the equity base (the ROE's denominator) of $114.003 million for CSP and $196.882 million for OPCo. (Cos. Ex. 2 at 7.)

B. Adjustment For Organizational Restructuring Program.

In April 2010, AEP announced an initiative to achieve workforce reductions through an organizational restructuring program. Accordingly, Mr. Mitchell added back the 2010 after-tax amounts of $20.995 million and $33.550 million for CSP and OPCo, respectively, to both the net earnings for common shareholders (numerator) and common shareholder equity which is used in the calculation of average equity (denominator). (*Id.* at 8.)

C. Adjustment For Change In Medicare Part D Subsidy.

Mr. Mitchell explained that the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act ("Health Care Acts") were enacted in March 2010. The Health Care Acts amend tax rules so that the portion of employer health care costs reimbursed by the Medicare Part D prescription drug subsidy will no longer be deductible by the employer for federal income tax purposes effective for years beginning after December 31, 2012. Because of the loss of the future tax deduction, Mr. Mitchell explained, the 2010 after-tax amounts of $2.871 million and $6.424 million for CSP and OPCo, respectively, have been added back to both net earnings available to common shareholders and common shareholder equity for purposes of the 2010 SEET review. (*Id.* at 9.)

D. 2009 SEET Adjustment

Mr. Mitchell explained that there was a special adjustment also necessary to give effect to the Commission's directive in Case No. 10-1261-EL-UNC, in which CSP was determined to have 2009 earnings subject to being returned to customers in the amount of

$42.683 million. In particular, in its Opinion and Order (at 35) in Case No. 10-1261-EL-UNC the Commission directed CSP:

> to apply the significantly excessive earnings, as determined in this Opinion and Order, first to any deferrals in the FAC account on CSP's books as of the date of this order, with any remaining balance to be credited to CSP's customers on a per kilowatt hour basis beginning with the first billing cycle in February 2011 and coinciding with the end of the current ESP period. Additionally, the Commission finds that any balance credited to CSP's customers will not be deducted from the Company's earnings for the purposes of the 2011 SEET review.

Mr. Mitchell reported that approximately $18.718 million of the $42.683 million was applied to recover deferred fuel amounts and approximately $23.965 million was being refunded to customers over the period February through December 2011. CSP had provided for the $42.683 million (pre-tax), which had reduced the 2010 per-books earnings. Because the Commission's Opinion and Order in Case No. 10-1261-EL-UNC specified that amounts credited to customers should not be deducted from the Company's earnings for purposes of any subsequent SEET review, Mr. Mitchell added back $27.411 million (after tax) to earnings and the equity base in order to adjust out this effect from 2010 SEET earnings. (*Id.* at 10-11.)

E. Companies Witness Mitchell Properly Calculated CSP's 2010 ROE To Be 17.54% (And OPCo's To Be 9.88%).

At the request of Companies witness Hamrock, Mr. Mitchell calculated CSP's earned return on equity for 2010, starting with the per books return of 16.17%. After excluding earnings associated with off-system sales (OSS) and reflecting the impacts of the three non-OSS related adjustments described above, Mr. Mitchell calculated an adjusted return of 17.54% for CSP. (Cos. Ex. 2 at 5-6 & Ex. TEM-1 at 1 of 5.) Similarly, Mr. Mitchell calculated an earned ROE for OPCo to be 9.88%. Mr. Mitchell's calculation of earnings is consistent with the Commission's Opinion and Order in Case No. 10-1261-EL-UNC and its Finding and Order in Case No. 09-786-EL-UNC. Staff witness Buckley reviewed Mr. Mitchell's calculations of both CSP's and OPCo's ROEs and found them to be in conformance with the SEET calculation methodology previously approved by the Commission and to be an accurate representation of their 2010 earnings. Accordingly, Mr. Buckley concurred that CSP's 2010 earned ROE is 17.54% and that OPCo's 2010 earned ROE is 9.88%. (Staff Ex. 1 at 2-3.)

F. OEG Witness Kollen's Recommendations Should Be Rejected

OEG witness Kollen raises several criticisms regarding how AEP Ohio (and the Staff) calculated CSP's earned ROE for 2010. Mr. Kollen's primary position is that no adjustment should be made to CSP's earned ROE to remove OSS-related earnings. (OEG Ex. 1 at 7-8.) Mr. Kollen's second position, if an adjustment is to be made, is that the percentage of equity removed from the denominator of the earned ROE should be equal to the percentage of OSS-related earnings removed from the numerator. (*Id.* at 11-13.) He bases this recommendation on his view that there is no reason to believe that the profitability of OSS is any greater or lesser than the profitability of retail sales. (*Id.* at 13.) This position really just boils down to his primary position that no adjustment at all should be made, because removing the same percentage from the numerator and the denominator results in precisely the same earned ROE after the adjustment as existed before the adjustment. (Tr. v. I at 112.) Mr. Kollen's third position regarding an OSS margins adjustment is that if the Commission follows the approach used by the Companies and accepted by Staff, it should conclude that the removal of OSS margins is cumulative and, therefore, it should deduct from the denominator OSS-related earnings from prior years, as well as the current year. (OEG Ex. 1 at 13-14.)

With regard to the other adjustments that Mr. Mitchell made that increased net income, and thus the ROE numerator, by a total of $51.277 million ($20.995 million for organizational restructuring expense; $2.871 million for a change in the Medicare Part D subsidy; and $27.411 million for the 2009 SEET refund), Mr. Kollen readily accepted those adjustments and the related increase in the numerator. However, he objected to also increasing the denominator by the amount of the 2009 SEET refund, the organizational restructuring and the Medicare Part D subsidy. (OEG Ex. 1 at 14-15.)

Mr. Kollen's criticisms regarding Mr. Mitchell's ROE adjustments are not persuasive. First, with regard to the OSS adjustment, in Case No. 10-1261-EL-UNC the Commission considered whether it is appropriate to adjust CSP's earned ROE to remove the impacts of OSS earnings. After considering the matter, the Commission concluded, in its Opinion and Order (at 31), that it was necessary to "reduce CSP's earnings to exclude OSS and similarly adjust the calculation to account for that portion of the generation facilities that supports OSS." Mr. Kollen and OEG are simply attempting to relitigate an issue that the Commission already has thoroughly considered and determined.

Second, Mr. Kollen's argument that, if an adjustment is made to the ROE to remove OSS earnings, it should be made by removing the same percentage of equity base from the denominator as earnings from the numerator is simply a creative way to reargue his first position – that no adjustment should be made. Again, the Commission has already considered this argument and concluded that an adjustment is appropriate. It is worth observing that the implication of Mr. Kollen's position is that equity used to support distribution and transmission functions should be allocated to OSS. That is clearly erroneous. It is appropriate, as the Commission already has determined, to limit the adjustment to the equity base to the portion of equity that supports production plant, i.e., the generation assets used to produce OSS.

Mr. Kollen's third position regarding OSS adjustments, if neither his first or second position is accepted, is that the removal of OSS margins from the denominator should be cumulative and should include the OSS margins from prior years as well as the current year. (OEG Ex. 1 at 14.) The irrationality of this recommendation is demonstrated by the fact that, if all else is held the same from year to year – OSS margins, net production plant, off-system-sales volumes, etc. – the amount of equity removed from the denominator would double and then triple in the second and third years of the exercise. That result would have the effect of arbitrarily increasing from year to year the earned ROE and, thus, the amount of earnings subjected to potential return to customers. Mr. Kollen provides no explanation as to why such a patently irrational result would be appropriate.

Nor is there any reasonable basis for Mr. Kollen's position that the numerator of the earned ROE should be increased (as the Companies recommend) in order to add back to earnings the impacts of the organizational restructuring expense, the change in the Medicare Part D subsidy, or the 2009 SEET refund, but the denominator should not be similarly increased. If it is appropriate to place the Company in the position it would have been in if those expenses had not been incurred (thus leading to the higher earnings in the numerator), it is also appropriate to recognize that the equity base would have likewise been larger by the same amount.

III. Appropriate 2010 Return On Equity Threshold for the SEET

Companies witness, Dr. Anil K. Makhija, presented a scientifically-supported methodology, employing well-respected and widely-utilized data and metrics, that he developed to implement the SEET, paying particular attention to the specific terms used in R.C. 4928.143(F). See Direct Testimony, Companies Ex. 3, and Rebuttal Testimony, Companies Ex. 11.[1] In a similar manner to the methodology that he sponsored in the prior SEET proceeding involving the Companies, Dr. Makhija implemented a methodology to establish an appropriate 2010 return on equity threshold for the SEET applicable to CSP and OPCo that has two basic components. The first component 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 ("CRPG"), 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 6, 2011, he employed a 5 x 5, or 25 cell, methodology to identify the CRPG 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

[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. (Cos. Ex. 3 at 1-3.)

(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 CRPG. Measuring the earned ROEs of the CRPG as normal earnings on average common equity, he obtained that group's mean earned ROE, which is 11.48%. (Cos. Ex. 3 at 7 & 35-39, 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 CRPG plus 1.96 times the standard deviation of the ROEs for the CRPG. It is against this ROE Threshold that the ROEs for CSP and OPCo for 2010 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 most commonly applied standard, and (2) because it provides for a reasonably acceptable risk of false positives. (*Id.* at 31.) Dr. Makhija determined that the standard deviation of the CRPG is 5.68% and, thus, a 1.96 standard deviation adder, corresponding to a 95% confidence level, is 11.13%. (*Id.* at 7.)

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, including but limited to utilities, 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, in this instances 68 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 6.) Dr. Makhija found that for 2010 the mean ROE of the CRPG is 11.48% and the standard deviation of the CRPG ROEs is 5.68%. Multiplying the 5.68% standard deviation by 1.96 produces an adder of 11.13%. Therefore, he concluded that the 2010 SEET ROE Threshold for CSP and OPCo, which is the sum of the mean ROE and the adder, is 22.62%. (*Id.* at 7.)

A. Mean Return On Equity During 2010 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 – the CRPG – 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." (*Id.* at 15.)

Dr. Makhija developed just such a methodology. He started with data from the *Value Line Standard Edition* for 2010, which constitutes Value Line's "flagship product" because it provides comprehensive coverage for the more prominent firms. (*Id.* at 17.) He first calculated for each U.S.-domiciled 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 captures firms that have comparable business and financial risk to AEP. Since SB 221 requires the Commission 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 17).

a. Business risk

Dr. Makhija explained that:

> Business risk is the risk arising from day-to-day business operations. For an electric [distribution] utility, 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 18.) He also observed that business risks for electric distribution utilities are higher in Ohio than in other states in part because of the migration risk associated with their provider-of-last-resort status and tariff rates and in part because the SEET is asymmetrical in that it does not provide for the recovery of past under-recoveries of revenue if the earned rates prove to be inadequate. (*Id.* at 19.)[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. 3 at 19-22.) The CAPM is "the preeminent model for measurement of risk" and "is by far the most widely used model for taking risk into account." (*Id.* at 19.) The financial risk component is removed, allowing the business risk to be measured, by unlevering those Value Line betas. Dr. Makhija enumerated a number of compelling reasons that recommend the use of unlevered betas to measure a firm's business risk, and noted "as a practical matter, betas have a greater acceptance than any alternative measure of risk." (*Id.* at 22-24.)

Dr. Makhija 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." (*Id.* at 24.) Dr. Makhija also observed that, using AEP's betas for CSP and OPCo

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[2] As discussed later, 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. (Cos. Ex. 1 at 15-18.)

in the SEET gives "a more conservative application of that test" because "AEP's beta understates the risks for CSP and OPCo." (*Id.* at 25.)

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 19.) To measure financial risk, Dr. Makhija used the book equity ratio, which is the (Average book value of equity beginning and end of 2010)/(Average of beginning and end of 2010 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 27.)

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 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 2010, downloaded as of June 6, 2011, which are presented in Table 1 to his Direct Testimony, confirm that the matching methodology he used to construct the CRPG 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 CRPG for 2010 (0.3145) is well matched with the book equity ratios for CSP (.3215) and OPCo (.3600). With respect to the unlevered betas, the mean for the comparable group, found in Panel C.2, is .3527. While this is higher than the unlevered beta for AEP (.2915), CSP and OPCo are expected to have higher unlevered betas than AEP. Accordingly, Dr. Makhija concludes that the CRPG provides a good, and likely conservative, match for business risk as well. (Cos. Ex. 3 at 37-38 & Table 1 at Panel B.)

Panel D of Table 1 to Dr. Mahkija's Direct Testimony, provides the membership of the CRPG for 2010. 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 48 out of the 68 of the comparable group of firms (excluding AEP) or about 71% are utilities. If regulated industries are counted, the number of firms in the comparable group goes up to 56/68 or about 82%. Twelve, or about 18%, come from non-regulated firms. (Cos. Ex. 3 at 39.) 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 CRPG 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. (*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 CRPG. Specifically, along with unlevered betas, he also employed capital intensity as an additional measure of business risk. (Cos. Ex. 3 at 25.) Similarly, along with book equity ratios, he used the Standard & Poor's Long-Term Issuer Credit Rating to measure financial risk. *(Id.* at 28.) As a result, his findings are supported by four "widely used and well-ground metrics" and are not overly reliant on a single business or financial risk metric. (*Id.*) 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. 3, at 6, 44-45.)

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 CRPG 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. (Cos. Ex. 3 at 12.) For the denominator he employed the average of beginning-of-the-year and end-of-the-year book common equity. (*Id.* at 13.)

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 2010)/(Average of Common Equity Reported for end of 2009 and Common Equity Reported for end of 2010).* The mean ROE for the CRPG is 11.4838% with a standard deviation of 5.6809%. (Cos. Ex. 3 at 41 & Table 1 at 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 CRPG. 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, "is the most commonly applied standard" and "offers, in his opinion, a reasonably acceptable risk of false positives." (*Id.* at 31.) This standard, when applied to the 5.68% standard deviation of the CRPG, translates into an adder of 11.13%. (*Id.* at 46.)

Dr. Makhija noted that it is natural for the ROEs of OPCo and CSP to differ from the mean ROE for the CRPG in any given year. (*Id.* at 29.) He explained why as follows:

> 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, I apply standard statistical theory, which is a reasonable method looking at this data. * * * The mean return for a sample of returns, about which there appears to be no controversy, 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. 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.

(*Id.*) Notably, the Commission has agreed, confirming in its June 30, 2010 Opinion and Order (at 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.

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, of course, is 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. (Cos. Ex. 3 at 30-34.) He looked at the implications of determining Threshold ROEs at various numbers of standard deviations above the mean for the CRPG. He observed that a 1.96 standard deviation adder implies, for a normal distribution[3] 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%. (*Id.* at 30.) In Dr. Makhija's opinion, ROE Thresholds based on 1.64 or 1.28 standard deviations would "allow for too high a risk of false positives." (*Id.* at 34.)

> 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%. These are high probabilities of false positives. 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 34.)

Dr. Makhija also provided several examples which confirm that the 95% confidence level and related 1.96 standard deviations is a commonly applied measure of statistical significance. Dr. Makhija cited the annual report of the U. S. Department of Education 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

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[3] Dr. Makhija also acknowledged that the distribution of the CRPG is skewed to the right and has fat tails. While a right-skewed fat-tailed distribution is not a normal distribution, Dr. Makhija 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. 3 at 40-41.)

figures is a "real difference" and not "due to chance," i.e., whether the difference is significant. (*Id.* at 32.) 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. (*Id.*) Yet another example comes from the United States Department of Justice Programs, Bureau of Justice Statistics, which puts out an annual report called the National Crime Victimization Survey. (*Id.* at 33.) 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.*)

In sum, at each step in his implementing methodology for the SEET, Dr. Makhija relied upon well-respected metrics and scientifically-validated procedures. His presentation stands as the only presentation before the Commission in this proceeding, or in any proceeding to date, that can make such a claim. The Ohio Supreme Court has repeatedly admonished the Commission that it must support its decisions with appropriate evidence, explain its rationale, and respond to contrary positions. See, e.g., *In re Application of Columbus S. Power Co.*, 128 Ohio St.3d 512, 2011-Ohio-1788 at ¶ 30. While the Commission has discretion, particularly when it comes to matters of a highly technical nature, it does not have the discretion to simply ignore an analysis that is conceptually sound, well-reasoned, well-supported and specifically-tailored to take into account each of the terms used in R.C. 4928.143(F). And, it abuses what discretion it has if it rejects such analysis, without valid reason, and then base its decision on a flawed theory with no scientific support or simply makes a "gut-call."

C. Staff Witness Buckley's Recommendations.

Staff witness Buckley presented the Staff's recommendation that the Commission find that OPCo's earned return on equity falls within the safe harbor but that CSP had significantly excessive earnings. (Staff Ex. 1 at 2.) The Staff's recommendation is based on what it concedes is a "simplistic process," that uses only one metric. (*Id.* at 5.) The Staff took the companies that comprise the SPDR Select Fund-Utility (XLU) as its comparable group, totaled the net income earned by those companies and divided it by the total common equity of each of the companies to produce a ROE of 10.19%. (Staff Ex. 3 at 1.) It adjusted this upward by 50%, based solely on the fact that the Commission concluded in the Companies' last SEET case that 50% is a reasonable adder. The Staff makes no effort to analyze whether a 50% adder would still be reasonable today. (*Id.* at 3-4.) Based solely on its overly-simplistic, mechanical exercise, the Staff concludes that "the threshold value of 15.29 percent . . . is reasonable" for purposes of administering the 2010 SEET. (Staff Ex. 1 at 4 & Ex. 3 at 1.)

On cross-examination, Mr. Buckley, re-characterized the 15.29% ROE as a "baseline," not a "threshold," conceding that the Staff expected that the Commission necessarily would adjust this number based on other factors that needed to be considered. He testified that there could be a "multitude of factors" the Commission might consider before reaching a final ROE threshold. (Tr. v. I at 133-34.) Yet, the Staff's recommendation in testimony was for the Commission to order a refund based on this tentative and incomplete analysis.

Mr. Buckley explained the Staff's rationale for using only the SPDR Index to establish a comparable group as follows:

> It was my hope that the SPDR would take out the difficult task of creating comparable groups, that someone, an independent party would create this comparable group and that we would just adopt that. They have different goals in selecting their group than we would in establishing baseline ROE, and in proceedings like this it seems like a lot of talk is centered around the comparable group and I wanted to try to simplify that and avoid that.

(Tr. v. I at 138.) But in opting for a simplistic methodology that relies on a group selected to meet entirely different goals, the Staff sacrificed the more important goal of finding a methodology and group that would be reasonably probative of whether the Companies' earnings were significantly excessive as compared to "publicly traded companies, including utilities, that face comparable business and financial risk." Mr. Buckley admitted that the SPDR group was not formed or changed based on a comparison to the business and financial risks of the Companies. (*Id.* at 138.) Brushing aside the actual words in the statute, "publicly traded companies, including utilities," the Staff apparently concluded that it would not be appropriate to look outside the electric utility industry for comparable firms. (*Id.* at 145.)

The Staff focused exclusively on the SPDR because it believed that the SPDR is made up of electric utilities, yet Mr. Buckley rightfully acknowledged that the SPDR is comprised of utilities at different levels of risk, and includes utilities other than electric utilities. (*Id.* at 145-46.) The SPDR classifies only about half the included firms as electric utilities. (*Id.* at 146.) Mr. Buckley further admitted that to his knowledge only a couple of the included utilities are in retail shopping jurisdictions and only one faced retail governmental aggregation. He did not know whether any of the SPDR firms operated in jurisdictions with renewable energy portfolio mandates and he assumed none were subject to a SEET. (*Id.* at 149-50.) The Staff analysis does nothing to take into account the obvious and indisputable fact that Ohio EDUs operate in a unique hybrid regulation environment fundamentally different from the environment in other states where traditional regulation remains the norm or the necessary and unavoidable consequence of this difference, which is that Ohio EDUs, especially those that continue to own their own generation, face significantly higher risks.

Mr. Buckley also admitted on cross-examination that the data he used to determine the ROE for the SPDR group came from two different sources – some of it came from Value Line and some from Google Finance – and as result there were errors in his calculations. (Tr., v. I at 152-163.) He also admitted that his calculation had the effect of weighting companies relative to their size, even though there was no reason to believed that the larger capital firms would be a better match to CSP's business and financial risks. (*Id.* at 155-56.) In his Redirect Testimony, Mr. Buckley corrected several obvious errors in his calculation of the ROEs for the SPDR group, but did not otherwise change his methodology. (Staff Ex. 4.)

There remain numerous, uncorrected flaws in the Staff's presentation, as explained by Dr. Makhija in his Rebuttal Testimony. See Companies Exhibit 11. First and foremost, the Staff's approach ignores the fact that R.C. 4928.143(F) explicitly requires an analysis using a comparable group of "publicly traded companies, including utilities, that face comparable business and financial risks" from the standpoint of the subject electric distribution utility. There is no reason to believe that all utilities or even all electric utilities face comparable business and financial risks. "For example, not all electric utilities engage in all three businesses, generation, transmission, and distribution, altering the extent of the business risk they face. Similarly, not all electric utilities have the same leverage or credit rating, altering the extent of financial risks they face." (Cos. Ex. 11 at 6.) The Staff approach makes no attempt to determine the extent of business or financial risks faced by the Companies and, as Dr. Makhija explains, there is no reason to think that the SPDR Index is a good match for the business and financial risks of the Companies. (*Id.*)

Second, the Staff's methodology is not even true to itself. Mr. Buckley testified that he picked this approach because the SPDR is composed on electric utilities, when in fact only about one half of the included firms are electric utilities. (Tr. v. I at 146-47.) Dr. Makhija explains why the inclusion of non-electric utility firms without a check on their business and financial risk is a matter of concern. (Cos. Ex. 11 at 7.) He notes, for example, that each of the non-electric utilities in the SPDR had higher betas than AEP and that none of these firms made a match with CSP in his analysis of the business and financial risks of all U.S.-domiciled publicly traded companies. (*Id.* at 7-8.)

Third, the Staff methodology uses a weighted average that gives the ROEs of the larger firms greater weights. The Companies are relatively smaller firms compared to the electric utilities in the SPDR. Thus, the weighted ROE procedure employed by the Staff "leads to mismatching the risk of the comparable group to that of CSP and OP." (*Id.* at 5.) Finally, the Staff presentation wrongfully includes AEP as part of the comparable group for CSP and OP. (*Id.* at 4.)

When the implementation and mathematical errors in the Staff's methodology are corrected, the mean ROE of the SPDR comparables is 11.42%, and not the 10.97% reflected in Mr. Buckley's Redirect Testimony. This corrected mean ROE is similar to the 11.48% proposed by Dr. Makhija. (Cos. Ex. 11 at 2.) If the Commission were to apply the same 60% adder it applied in the Companies' prior SEET proceeding to the mean ROE resulting from a correct implementation the Staff's over-simplistic methodology, it would produce a new Staff baseline of 18.27%. (*Id.*)

D. Conclusion Regarding Appropriate 2010 SEET ROE Threshold.

The Commission should find that for 2010 the mean ROE of the CRPG is 11.48% and the standard deviation of the CRPG ROEs is 5.68%. The Commission should further find that the appropriate adder to be used to establish the level at which the Companies earned ROE for 2010 may become significantly excessive is calculated by increasing the mean ROE by 1.96 standard deviations, which produces an adder of 11.13%, and that the Companies' 2010 SEET ROE Threshold, which is the sum of the mean ROE and the adder, is 22.62%.

IV. Initial Comparison Of CSP's And OPCo's 2010 Adjusted Return To ROE Threshold For SEET

As discussed below, using the Companies' testimony for establishing the ROE threshold and the Companies' ROEs produces the following results:

Quantitative SEET Comparison for 2009	**Safe Harbor ROE Test**	**Benchmark ROE Test**
ROE Threshold	13.48%	22.62%
CSP Earned ROE	17.54% adjusted (16.17% per books)	17.54% (16.17% per books)
OPCo Earned ROE	9.88% adjusted (9.70% per books)	9.88% (9.70% 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. The "Safe Harbor" Applies To OPCo's 2010 Earnings.

The Commission's June 30, 2010 Finding and Order in the SEET Investigation, Case No. 09-786-EL-UNC, 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 2010 is 11.48% (implying a safe harbor of 13.48%), while Staff witness Buckley's recommendation is 10.97% (implying a safe harbor of 12.97%). Because OPCo's 2010 earned ROE of 9.88% is less than the safe harbor limit suggested by either the Companies or Staff in this proceeding, OPCo's 2010 earned ROE should not be subject to further SEET analysis.

B. CSP's 2010 Earnings Are Not Above The Appropriate ROE Threshold.

CSP's 2010 earnings are not above the appropriate 2010 ROE threshold and the Commission should not make a finding that significantly excessive earnings existed for CSP in 2010. Based on Dr. Makhija's ROE threshold recommendation of 22.62%, there are no significantly excessive earnings either based on CSP's earnings that exclude OSS margins of 17.54% or its unadjusted, per books earnings of 16.17%.

C. Staff Witness Buckley's Recommendation That CSP Refund Overearnings Should Not Be Accepted.

While Staff Witness Buckley agrees that OPCo passes the safe harbor test, he ultimately concludes that CSP had overearnings of $14.442 million. (Staff Ex. 4 at 2.) He applies a gross revenue conversion factor to his finding of overearnings and then recommends that CSP be ordered to refund of $22.577 million. The Commission should reject the Staff's position because its methodology for determining a comparable group fails to comport with any reasonable interpretation of the SEET statute and because Mr. Buckley conceded that the Staff had not, and could not, make a recommendation as to the ultimate comparable group ROE threshold, a necessary and critical step in the SEET analysis.

The reasons why the Staff's comparable group methodology is fundamentally flawed were disclosed through cross-examination and are further documented in Dr. Makhija's rebuttal testimony. (Tr. v. I at 138-151; Cos. Ex. 11.) To summarize, the Staff's methodology did not produce a reasonable comparable group ROE because the Staff chose as its "comparable group" a group determined without any thought as to whether the included firms would be comparable to CSP in terms of business risk or financial risk and then weighted the ROEs for that already incomparable group to emphasize larger firms, even though CSP would be a relatively smaller firm compared to the group members. Thus, the Staff's presumed comparable group ROE of 10.97% is not a reasonable starting point for purposes of the SEET analysis.

Moreover, the Staff does not suggest its ultimate number, which apparently now is 16.45% (10.97% x 1 + 50 percent), is the threshold the Commission should use in its analysis. Staff witness Buckley offers this as only a "baseline" and concludes that the Staff intended to leave it to the Commission to decide the appropriate threshold depending on any number of factors the Commission might choose to employ. (Tr. v. I at 132-133.)

The Staff's analysis is limited to a mechanical exercise that multiples its baseline number by a 50% adder because the Commission suggested in CSP's last proceeding that a 50% adder would be reasonable. (Staff Ex. 3 at 4.) The Staff's rationale for proposing the 50% adder in the 2009 SEET case was limited to its observation that "subtracting the adder from the comparable ROE yields a result that is near CSP's cost of debt." *SEET I*, Opinion and Order at 20. Reliance on this single observation to justify its ROE baseline or threshold is clearly erroneous in that the statute suggests that the benchmark is to be derived from the metrics of the comparable group, not the subject EDU. In addition, this 50% adder equates to a standard deviation adder of less than 1.0, which poses an unacceptably high risk (more than one out of three) of erroneously finding an EDU to have significantly excessive earnings. (See Cos. Ex. 3 at 31.)

Finally, even if the Commission elects to follow the Staff's simplistic approach, it should at a minimum correct the indisputable flaws in the Staff's implementation of its methodology and use an adder no less than that applied in 2009. As Dr. Makhija demonstrated on rebuttal, correcting these implementation flaws and using a 60% adder produces an ROE threshold of 18.27%, which results in CSP comfortably passing the benchmark test.

V. Earnings From Only Five Of The Companies' ESP Rate Adjustments Are Subject To Refund If Those Adjustments Caused Significantly Excessive Earnings In 2010

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 2010, 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" 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.

The Commission's June 30 Finding and Order in Case No. 09-786-EL-UNC (at 14-15) found 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 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 2010 filing. For CSP, calculating the total 2010 earnings resulting from the earnings-producing rate adjustments authorized under the ESP, as Companies 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;

4. Incremental POLR revenues over and above CSP's pre-ESP POLR charges; and

5. Equity return on post-2008 environmental investments as recovered in 2010 through the environmental investment carrying cost rider.

(Cos. Ex. 1 at 11.) Companies witness Mitchell calculated CSP's earnings associated with the above-listed ESP adjustments. CSP's 2010 total after-tax earnings associated with the five adjustments are $60.3 million, which corresponds to a pre-tax revenue amount for 2010 of $93.9 million. (*Id.*; see also Cos. Ex. 2 at 12.)

VI. 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 R.C. 4928.143(F) 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 also allows 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 presented substantial evidence of the capital requirements for 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 2009 through 2011 in Exhibit JH-1 to his testimony. (Cos. Ex. 1, Ex. JH-1.) Exhibit JH-1 shows that AEP Ohio has spent or planned to spend capital investments of approximately $1.6 billion during the ESP term, $1.1 billion spent as of December 31, 2010. Mr. Hamrock confirmed that this data provides a consistent picture of AEP Ohio's present and future capital investments in Ohio during the ESP term. The information reflects actual data associated with the total construction expenditures and future projected capital expenditures. By any measure, this is a tremendous amount of capital investment in Ohio, made during a relatively uncertain regulatory environment, and should carry significant weight in the Commission's 2010 SEET analysis for AEP Ohio. (Cos. Ex. 1 at 19-20.)

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, Mr. Hamrock explained that as many as 600 jobs would be created by the solar farm project. Moreover, any capital investment in Ohio that is likely to bring new tax base, new jobs, increased support for the broad range of customers is beneficial to all the state's residents. (*Id.* at 14, 20)

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 2010.

VII. Capital Investments And Other Considerations.

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.

In their recently decided distribution service rate cases, the Commission adopted a Stipulation and Recommendation that agreed and recommended that CSP and OPCo are entitled to returns on equity of 10.0% and 10.3%, respectively. Case Nos. 11-351-EL-AIR and 352-EL-AIR, Opinion and Order, at 5 (December 14, 2011). However, consideration of any current return on equity considerations applicable to distribution operations alone must be tempered by the recognition that an electric distribution utility that continues to own generation assets, faces risks above and beyond those of a distribution utility that does not own generation assets. 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 Companies' Risks.

Mr. Hamrock identified the most prevalent risks facing the Companies as "cost recovery for the cost to comply with new and anticipated environmental regulations, customer expectations of low power costs coupled with increasing performance expectations, customer migration within the state, ongoing regulatory litigation, and a stagnant national and state economy. (Cos. Ex. 1 at 15.) With respect to the risk imposed by environmental regulations, Mr. Hamrock noted that pending federal mandates will cause AEP Ohio to permanently retire certain Ohio generation plants and units and to make costly retrofits to other Ohio units. Yet, AEP Ohio is not assured of recovery of its existing generation assets due to changes in state regulatory views and federal environmental statutes within a rapidly changing market. (*Id.* at 16.) Mr. Hamrock also explained that while the current ESP includes a fuel adjustment clause, the collection of these costs is limited to an annual threshold and is bypassable. (*Id.*)

Mr. Hamrock further testified as to the impact of the Companies' regulatory risk, describing in particular the risk associated with regulatory lag and deferrals and how the resulting rate volatility "impacts the timing of cash flow which can also potentially impact an EDU's credit rating." (*Id.* at 17.) He concluded that the "combination of outstanding deferred assets, Senate Bill 221 requirements, environmental mandates, and ESP timing, forces AEP Ohio into an elevated level of risk." (*Id.*) Mr. Hamrock also addressed the migration risk and its consequences. (*Id.* at 18.) He noted that as of June 2011, CSP's load switching equated to 19.6%, and explained that customer switching at elevated percentages over the near term intensifies the cost recovery risk for CSP. (*Id.*)

All of these additional risks should be considered by the Commission in implementing the SEET. In this proceeding, the Commission should recognize and carefully consider 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. 1 at 17-18.) Mr. Hamrock testified that, while these reliability indices indicate comparable performance with prior years, AEP Ohio will need to make substantial and continuing investments in infrastructure to maintain or improve performance. (*Id.* at 18.)

D. Innovation And Industry Leadership With Respect To Meeting Challenges To Maintain And Improve Competitiveness Of Ohio's Economy.

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. 1 at 12-14.) 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, and a steady stream of investment that have maintained a significant tax base throughout the state.

In implementing the Commission's Alternative Energy Portfolio Standard rules, AEP Ohio led a DSM collaborative to develop energy efficiency and demand response programs (EE/PDR) and gridSMART initiatives. Through these programs, AEP Ohio customers have the potential to save through reduced electricity bills over the life of the programs and by helping to reduce power plant emissions. AEP Ohio's energy efficiency and peak demand response programs met or exceeded the benchmark requirements for both areas in 2009 and 2010. (*Id.* at 13.) Additionally, AEP Ohio's gridSMART – Phase 1 project further demonstrates leadership in the industry. It includes the installation of smart meters, distribution automation equipment, real-time pricing, demand dispatch, and numerous other advanced features that enhance the electricity infrastructure. In addition, by meeting U.S. Department of Energy (DOE) standards, the gridSMART project has been able to obtain 50% funding from the DOE, thus limiting ratepayer impact while enhancing customers' ability to save energy and money. (*Id.* at 13-14.)

Mr. Hamrock also reported that in 2010, AEP Ohio initiated a process that would not only build solar and wind facilities in Ohio, but help the alternative energy supply chain grow and develop in the state. One such project, an 80-acre solar project in Wyandot County, is Ohio's first utility scale solar power facility in which all the output is purchased through contract by AEP Ohio. Another project, the Turning Point Solar ("TPS") facility, will be one of the largest commercial solar developments with 49.9 MW of planned solar generation. The TPS facility is projected to create approximately 600 jobs in construction and facility management, with 300 remaining as new, permanent manufacturing positions within the state. AEP Ohio has committed to purchase the output of the project and has provided the use of approximately 650 acres of AEP Ohio land for TPS's use. Thus, AEP Ohio is promoting diversity of electricity supplies and suppliers while maximizing value within the State. (*Id.* at 14.)

E. The Extent To Which The Electric Utility Has Advanced State Policy.

Mr. Hamrock also described various ways in which AEP Ohio has advanced state policy. Not only is AEP Ohio investing capital in assets and facilities in Ohio, but during 2010 AEP Ohio also paid more than $676 million in Ohio payroll and approximately

$335 million in property, state and local taxes, not including philanthropic contributions, and purchases of Ohio goods and services. (*Id.* at 20.) AEP Ohio led the implementation of EE/PDR programs that resulted in CSP achieving 190% and OPCo achieving 135% of its benchmark requirements in 2010. (*Id.*) 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 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.*)

Mr. Hamrock further noted that contributions to the emerging solar power industry through AEP Ohio's commitment to purchase and invest in Ohio renewable solar power on a commercial basis beginning in 2010 and beyond demonstrates AEP Ohio's advancement of Ohio's renewable goals. Also, the investment in Ohio solar programs simultaneously supports the economic development within the State by supporting new Ohio jobs. The TPS project, for example is expected to create approximately 600 jobs, with 300 of those anticipated to be permanent. Finally, Mr. Hamrock observed, AEP Ohio has pledged contributions to the Partnership with Ohio Fund during the 2009-2011 ESP to be used across the AEP Ohio service territory for food banks, United Way programs, and other public-private partnerships in the state and local development arenas. (*Id.* at 20-21.)

CONCLUSION

For the foregoing reasons, the Commission should find that OPCo and CSP have demonstrated that neither company had significantly excessive earnings in 2010.

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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 and/or First-Class U.S. Mail upon counsel for all parties of record identified below this 31st day of January, 2012.

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