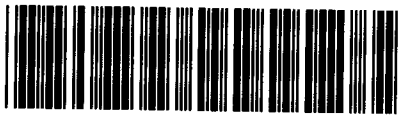
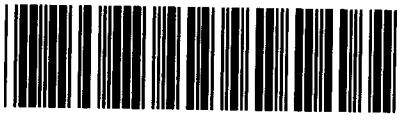


Control Number: 40443



Item Number: 1006

Addendum StartPage: 0

SOAH DOCKET NO. 473-12-7519
PUC DOCKET NO. 40443

2013 MAR -6 PM 2:32

FILING CLERK

APPLICATION OF SOUTHWESTERN ELECTRIC POWER COMPANY FOR AUTHORITY TO CHANGE RATES AND RECONCILE FUEL COSTS	§ § § §	BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS

SWEPCO'S INITIAL BRIEF
(REDACTED)

TABLE OF CONTENTS

1006

SOAH DOCKET NO. 473-12-7519
PUC DOCKET NO. 40443

APPLICATION OF SOUTHWESTERN ELECTRIC POWER COMPANY FOR AUTHORITY TO CHANGE RATES AND RECONCILE FUEL COSTS	§ § § §	**BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS**

SWEPCO'S INITIAL BRIEF

Southwestern Electric Power Company (SWEPCO or Company) files this Initial Brief.

I. Introduction/Summary [Preliminary Order (PO) Issues 1, 2]

As a regulated utility operating in the State of Texas, SWEPCO has the obligation to reliably serve its customers. To fulfill its obligation to serve, the Company must create long-term plans; acquire necessary capital funding; permit, construct, and maintain an infrastructure sufficient to meet the needs of its customers and the communities it serves; incur the appropriate level of expenses to support its operations; and responsibly steward its resources to ensure that its service is reasonably priced. Pursuant to Commission certifications, SWEPCO has been expanding its generation fleet since 2007 to provide service to its customers now and into the future. Now that the Company has fulfilled its obligation relative to the new Harry D. Mattison, J. Lamar Stall, and John W. Turk, Jr. plants, appropriate rate relief will allow SWEPCO to recover the cost of investment to provide service to customers for generations to come.

Even with full implementation of all requested rate relief, SWEPCO's residential rates will remain the lowest of all non-ERCOT utilities operating in Texas and its commercial and industrial rates will remain below all but one.[1] And that one utility is currently seeking an increase in rates from the Commission.[2]

---

[1] Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 at 22-23.

[2] Southwestern Public Service Company is currently seeking a nearly $90 million increase in its Texas jurisdictional rates in Docket No. 40824.

II. Rate Base [PO Issues 6, 8, 9]

A. Turk Plant [PO Issues 6, 9, 16, 17, 31]

1. Conditions of CCN [PO Issue 17]

In PUCT Docket No. 33891, the Commission conditionally granted SWEPCO's application to amend its CCN to include the Turk Plant "upon SWEPCO's receipt of all permits and agreements required for the construction and operation of the Turk Plant."[3] In addition, the Commission ordered that the "cap on the capital costs that Texas retail consumers may be responsible for is the Texas jurisdictional allocation of $1.522 billion."[4] SWEPCO has complied with the condition, and its requested rate relief is within the cap. SWEPCO received all necessary permits to construct and operate the plant.[5] The indisputable fact that Turk has been built and is operating is the end of the inquiry under any rational reading of the CCN order. And the equally indisputable fact that test year Turk expenditures are less than the Company's jurisdictional share of the Commission-approved cost cap is dispositive of the cost cap issue.[6]

Despite these facts, multiple Intervenor witnesses claim that SWEPCO has failed to comply with either the condition or the cap. But these claims are manufactured from thin air, with no relation to the undisputed facts or the CCN order. They should be rejected.

a. Receipt of required permits

The only question raised regarding SWEPCO's compliance with the condition that it obtain "all permits and agreements required for the construction and operation of the Turk Plant" is whether the condition obligates SWEPCO to possess a Certificate of Environmental Compatibility and Public Need (CECPN) from the Arkansas Public Service Commission (APSC). The answer is obviously no, given that the Turk Plant has been built and is operating.

Texas Industrial Energy Consumers (TIEC) witness Jeffry Pollock[7] implies that the CCN order requires a valid CECPN from the APSC. Office of Public Utility Counsel (OPUC) witness

---

3 Docket No. 33891 Order, SWEPCO Ex. 102 at Ordering Paragraph 1.

4 Docket No. 33891 Order, SWEPCO Ex. 102 at Ordering Paragraph 2.

5 Rebuttal Testimony of Thomas P. Brice, SWEPCO Ex. 66 at 4-5, 22; Direct Testimony of John C. Hendricks, SWEPCO Ex. 29 at 6; Rebuttal Testimony of Paul W. Franklin, SWEPCO Ex. 71 at 6.

6 Rebuttal Testimony of Thomas P. Brice, SWEPCO Ex. 66 at 24.

7 During the hearing on merits, Mr. Pollock conceded the fact that the Turk Plant is currently operating without a CECPN in Arkansas. Tr. at 963. He also admitted that he is not aware of any pending enforcement action against the plant. Tr. at 963-64.

Karl Nalepa[8] expressly asserts that unsupportable claim. Neither witness's argument is based on the language of the CCN condition, which makes no mention of a CECPN. Instead, their arguments are based on testimony of SWEPCO's President, Venita McCellon-Allen, during the CCN proceeding to the effect that SWEPCO would not build the Turk Plant if it did not obtain a CECPN.[9] While certain intervenors had much fun at the hearing with the prior testimony, their theory has no substance, for it ignores that SWEPCO did, in fact, obtain a CECPN.[10] Ms. McCellon-Allen stood behind her prior testimony and unambiguously testified here that had SWEPCO not received the CECPN, it would not have sited the plant in Arkansas.[11] When the Arkansas Supreme Court reversed the CECPN, SWEPCO continued construction of the plant pursuant to an exemption provided by Arkansas law. The Company properly notified the APSC of its intent to proceed under the exemption. The Company notified the PUCT as well.[12] Neither Mr. Nalepa nor Mr. Pollock contends this course of action was unlawful. The Arkansas Supreme Court's decision was an unforeseeable event, occurring years after construction began and after hundreds of millions of dollars had been invested. It does not change the plain terms of the CCN order. All permits and agreements necessary to the construction and operation of Turk were obtained as a matter of fact and a matter of law.

b. Cost cap

The PUCT set the Turk cost cap at $1.522 billion.[13] SWEPCO notes that the validity of the cost cap remains under review by the Supreme Court of Texas, but acknowledges that the ALJs are bound by the terms of the CCN order unless and until it is set aside. SWEPCO's share of the cap is $1.116 billion.[14] In this case, SWEPCO has requested that $1.106 billion of Turk

---

8 Mr. Nalepa admits that SWEPCO has "received all of the environmental permits required to construct and operate the Turk Plant." Redacted Direct Testimony of Karl Nalepa, OPUC Ex. 1 at 12.

9 Redacted Direct Testimony of Karl Nalepa, OPUC Ex. 1 at 13-14; Redacted Direct Testimony of Jeffry Pollock, TIEC Ex. 1 at 20-21.

10 SWEPCO's CECPN from the APSC was valid until the motion for rehearing of the Arkansas Supreme Court's decision reversing the APSC's order granting the CECPN was denied. Ark. Sup. Ct. Rule 5-3(a); Ark. R. Civ. P. 62.

11 Rebuttal Testimony of Venita McCellon-Allen, SWEPCO Ex. 65 at 21.

12 Rebuttal Testimony of Thomas P. Brice, SWEPCO Ex. 66 at 24.

13 Docket No. 33891 Order, SWEPCO Ex. 102 at Ordering Paragraph 2.

14 Rebuttal Testimony of Thomas P. Brice, SWEPCO Ex. 66 at 25.

construction work in progress (CWIP)[15] be included in rates.[16] Consequently, the cost cap has not been exceeded.

Mr. Pollock agrees that SWEPCO's request is less than its share of the cost cap.[17] Nevertheless, he and Cities witness Lane Kollen suggest that SWEPCO exceeded the cap because the Company took an impairment loss of $49 million on its accounting books in December 2011.[18] Mr. Pollock notes a second impairment loss for $13 million recognized in the 3rd quarter of 2012.[19] These impairment losses were necessary from an accounting perspective because in the coming year the Turk Plant costs were projected to exceed the cost cap.[20] But the impairments were not related to the actual cost incurred as of December 31, 2011, or the rate request at issue in this case.[21] Nor do the impairments reduce CWIP balances, being recorded to FERC Account 116 instead.[22]

Mr. Pollock also contends that SWEPCO has exceeded the cost cap by at least $253 million, based on his estimate of the cost to replace the capacity of Welsh Unit 2.[23] Mr. Pollock argues that any costs incurred as a result of retiring Welsh Unit 2 are essentially additional costs associated with the Turk Plant because the need to replace Welsh Unit 2 capacity is an attendant impact of the Turk Plant.[24] Mr. Pollock's argument is an unreasonable and transparent attempt to lower the Turk CWIP balance that otherwise would be placed into rates.

Mr. Pollock admits that the PUCT cost cap does not include any costs associated with Welsh Unit 2.[25] He also admits that his client – TIEC – attempted to get Welsh-related costs

---

15 This number includes over $10 million in capital spares and water rights not included in the cost cap. Direct Testimony of Christian T. Beam, SWEPCO Ex. 28 at 63-64.

16 Rebuttal Testimony of Thomas P. Brice, SWEPCO Ex. 66 at 25.

17 Redacted Direct Testimony of Jeffry Pollock, TIEC Ex. 1 at 19, 21; Tr. at 966.

18 Direct Testimony of Lane Kollen, Cities Ex. 3 at 17-21; Redacted Direct Testimony of Jeffry Pollock, TIEC Ex. 1 at 23.

19 Redacted Direct Testimony of Jeffry Pollock, TIEC Ex. 1 at 23.

20 Rebuttal Testimony of Thomas P. Brice, SWEPCO Ex. 66 at 17-18.

21 Rebuttal Testimony of Thomas P. Brice, SWEPCO Ex. 66 at 18; Rebuttal Testimony of Randall W. Hamlett, SWEPCO Ex. 73 at 17-20.

22 Rebuttal Testimony of Randall W. Hamlett, SWEPCO Ex. 73 at 18.

23 Redacted Direct Testimony of Jeffry Pollock, TIEC Ex. 1 at 24-29.

24 Redacted Direct Testimony of Jeffry Pollock, TIEC Ex. 1 at 25.

25 Tr. at 956.

included in the cost cap and the Commission declined to do so.[26] Moreover, Welsh Unit 2 has not been retired. It served customers in the test year, and continues to serve Texas customers today.[27] Thus, there are no replacement costs to even consider at this time. Finally, Mr. Pollock agreed that his "replacement cost" figure is just a "guesstimate."[28]

As discussed *infra* at Section II.A.3., the pending retirement of the Welsh Unit 2 is not an attendant impact of the Turk Plant. Mr. Pollock's efforts to calculate, well in advance of the retirement of Welsh Unit 2, the impacts of that retirement on capacity costs highlights the impropriety and prematurity of his claim.[29] There are no replacement capacity costs to be considered, and any impacts of the Welsh Unit 2 retirement should be considered when that retirement becomes fact, as all other intervenor witnesses addressing the subject acknowledged.[30]

2. Turk Decisional Prudence [PO Issue 9]

a. Background of need and selection of the Turk Plant

The Turk Plant is an ultra-supercritical pulverized coal steam generator operating at advanced steam conditions powering a single re-heat steam turbine generator.[31] The plant employs a state-of-the-art emissions control system – the Air-Quality Control System – to ensure reliable compliance with stringent emissions regulatory requirements.[32] The Turk Plant is one of the cleanest, most efficient coal-fueled plants in the United States.[33]

The completion of the Turk Plant marks the end of a nearly seven-year construction cycle, which was set in motion by SWEPCO's 2005 Integrated Resource Plan (IRP). The goal of the 2005 IRP was to identify and develop a plan to address SWEPCO's long-term capacity

---

26 Tr. at 977-78.

27 Rebuttal Testimony of Thomas P. Brice, SWEPCO Ex. 66 at 18.

28 Tr. at 978.

29 Rebuttal Testimony of Thomas P. Brice, SWEPCO Ex. 66 at 25-26.

30 SWEPCO agrees with Mr. Kollen's assessment that the Commission "cannot realistically and comprehensively review" the retirement of the Welsh Unit 2 in this case. Direct Testimony of Lane Kollen, Cities Ex. 3 at 42, 44.

31 Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 at 16.

32 Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 at 16.

33 Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 at 16.

resource needs.[34] The 2005 IRP identified a short-term capacity need for roughly 600 MW of capacity by 2008 and a longer-term capacity need of nearly 1,200 MW by 2012.[35]

SWEPCO's 2005 IRP also identified the types of resources needed using an industry-proven, proprietary modeling application – Strategist.[36] Based on an array of optimized results, SWEPCO developed a capacity resource build plan with a mix of generation types, including gas peaking, gas combined cycle, and solid-fuel baseload generation.[37] Ultimately, the 2005 IRP called for a total of 1,387 MW of generating resources comprised of:

- 462 MW of gas peaking (combustion turbine) capacity by June 2008;
- 479 MW of gas intermediate (combined cycle) capacity by June 2010; and
- 446 MW of solid-fuel (supercritical coal) capacity by June 2011.[38]

To obtain these resources, SWEPCO issued a formal request for proposals (RFP) in December 2005 for up to 500 MW of peaking capacity, up to 500 MW of intermediate/load-following capacity, and up to 600 MW of baseload capacity.[39] This RFP process was required by the Louisiana Public Service Commission (LPSC) and overseen by an independent monitor.[40] The RFP sought a combination of resources that would optimize the total production costs of SWEPCO, while providing the important benefit of fuel diversity.[41] Ultimately, the Company selected peaking (Mattison Plant) and intermediate (Stall Plant) resources fueled by natural gas and a baseload resource (Turk Plant) fueled by coal.[42] The selection of the resources optimized the total production costs of SWEPCO and allowed the Company to continue its highly successful generation strategy of fuel diversity.[43]

---

[34] Direct Testimony of Scott C. Weaver, SWEPCO Ex. 27 at 7; Docket No. 33891, Order, SWEPCO Ex. 102 at FoF No. 11.

[35] Direct Testimony of Scott C. Weaver, SWEPCO Ex. 27 at 8.

[36] Direct Testimony of Scott C. Weaver, SWEPCO Ex. 27 at 9.

[37] Direct Testimony of Scott C. Weaver, SWEPCO Ex. 27 at 9.

[38] Direct Testimony of Scott C. Weaver, SWEPCO Ex. 27 at 9-10.

[39] Direct Testimony of Scott C. Weaver, SWEPCO Ex. 27 at 10-11.

[40] Direct Testimony of Thomas P. Brice, SWEPCO Ex. 26 at 38.

[41] Direct Testimony of Thomas P. Brice, SWEPCO Ex. 26 at 59.

[42] Direct Testimony of Thomas P. Brice, SWEPCO Ex. 26 at 59.

[43] Direct Testimony of Thomas P. Brice, SWEPCO Ex. 26 at 59.

The Turk Plant, in particular, was selected as the baseload resource because it best satisfied the objectives of the RFP and complemented SWEPCO's successful long-term strategy of fuel diversity.[44] Moreover, the Turk Plant offered the lowest cumulative present value for the baseload resources evaluated in the RFP.[45]

In its Order in PUCT Docket No. 33891, the PUCT found that SWEPCO properly considered alternatives to the Turk Plant and concluded that the Company met its burden of demonstrating its need for the additional generation.[46] The Commission also recognized the benefits associated with fuel diversity:

> Additionally, the record reflects testimony and evidence on the relative price volatility of fuel sources, specifically coal versus natural gas. The Commission finds that for the foreseeable future, coal prices are most likely to be less volatile than natural gas and that it is ideal to maintain a balanced mix of fuel sources.
>
> The Commission takes note that it has recently approved two gas generation units for SWEPCO. Consequently, the Turk Plant will help SWEPCO to maintain its diversified fuel portfolio for its generation fleet. A diversified fuel portfolio is especially important in light of increasing natural gas prices. SWEPCO's generation mix (coal, lignite, and natural gas) helps to prevent SWEPCO from becoming dependent on one type of fuel.[47]

The benefits of fuel diversity remain valid today despite fluctuating gas prices. In fact, in the last year the Mississippi Public Service Commission reaffirmed its decision to grant a CCN for a lignite plant, with full knowledge of recent gas prices, to obtain the benefits of fuel diversification and price stability for that state's consumers.[48] Closer to home, the LPSC found that extending the life of SWEPCO's Dolet Hills lignite plant through the purchase of the Oxbow lignite reserves would allow continued "desired fuel diversity."[49] Even Cities Advocating Reasonable Deregulation (CARD) witness Scott Norwood acknowledged the benefits of fuel diversity during the hearing on the merits when he agreed that "natural gas prices are inherently

---

[44] Direct Testimony of Thomas P. Brice, SWEPCO Ex. 26 at 51.

[45] Direct Testimony of Thomas P. Brice, SWEPCO Ex. 26 at 51.

[46] Docket No. 33891 Order, SWEPCO Ex. 102 at FoF No. 23 and CoL No. 9.

[47] Docket No. 33891 Order, SWEPCO Ex. 102 at 5-6.

[48] Rebuttal Testimony of Thomas P. Brice, SWEPCO Ex. 66 at 7-8 (citing *Petition of Mississippi Power Company for a Certificate of Public Convenience and Necessity*, Docket No. 2009-UA-014, Final Order on Remand (Miss. Public Service Commission, April 24, 2012)).

[49] LPSC Order No. U-30975 at 4; Direct Testimony of Lane Kollen, Cities Ex. 4 at Attachment 41; SWEPCO's Response to TIEC RFI 2-7, SWEPCO Ex. 104.

volatile" and that "utility systems that maintain a diverse set of energy resources are most likely to be able to protect customers against periods in which gas prices surge."[50] This Commission confirmed those observations just last year, noting: "Natural gas prices are volatile; they can increase or decrease substantially over the course of a few years. They are therefore difficult to accurately forecast."[51]

b. Construction of Turk Plant

Despite some intervenor arguments, the issue in this case is not whether the capacity supplied by the Turk Plant was needed when it was selected and the PUCT issued SWEPCO a CCN. That is res judicata. Nor has any party claimed that SWEPCO was imprudent in selecting the Turk Plant to meet its baseload capacity resource needs.[52] The issue raised by TIEC is whether it was prudent to complete construction of the Turk Plant in light of changing economic conditions. TIEC's Mr. Griffey, in conjunction with OPUC's Mr. Nalepa, opines that a reasonable utility manager would have decided to cancel construction of the Turk Plant in June 2010 because:

- the alleged market value of the plant at that time was less than the cost to complete;
- gas prices had fallen below the purported break-even point for the plant; and
- the Company's contemporaneous capacity margin forecasts showed no long-term need for the plant.

The suggestion that a reasonable utility manager would have canceled the Turk Plant in June 2010 is based on distortion of the actual facts and misuse of irrelevant information.

---

[50] Tr. at 1015 (reciting and agreeing with comments he filed with the Oklahoma Corporation Commission on behalf of the Oklahoma Industrial Energy Consumers).

[51] *Rulemaking Proceeding to Implement HB 971, Relating to Economic Criteria for a Certificate of Convenience and Necessity for an Electric Transmission Project*, Project No. 39537, Order Adopting Amendment to §25.101 as Approved at the March 7, 2012 Open Meeting at 2 (Mar. 21, 2012).

[52] Although in Mr. Griffey's world, there is no such thing as a baseload plant, and the very notion is "economic nonsense." Redacted Direct Testimony of Charles Griffey, TIEC Ex. 4 at 46.

i. SWEPCO's ongoing monitoring of the Turk Plant

Mr. Griffey repeatedly asserts that SWEPCO did not monitor the economic viability of the Turk Plant and claims that SWEPCO's position is that "once it has a CCN for a plant, it need only manage the plant's construction to budget and schedule."[53] Both claims are false.

SWEPCO witness Thomas Brice explains in his direct and rebuttal testimonies that the Company continually monitored the economic viability of the Turk Plant during both the planning and construction phases.[54] Specifically, Mr. Brice describes a series of analyses performed by ICF International[55] designed to determine whether SWEPCO's baseload capacity need was best met with the Turk Plant as opposed to a natural gas-fired combined cycle (NGCC) plant, which would be the only viable resource option to satisfy the need identified by the IRP.[56]

The original ICF analysis evaluated the projected production costs and present value of revenue requirements associated with three portfolios or combinations of power plant options available to SWEPCO to meet its growing demand levels.[57] The evaluation considered a range of economic uncertainties, including natural gas prices, potential future regulations of power plant air emissions (notably, CO_2) and capital costs for new power plants.[58] The ICF analysis confirmed that the Turk Plant was the best long-term option for SWEPCO and its customers.[59]

During the Turk CCN proceedings, the PUCT requested an update to the ICF report to account for the environmental control costs to reduce the emissions at the Welsh unit.[60] The updated analysis included approximately $350 million of control costs.[61] The updated analysis

---

53 Redacted Direct Testimony of Charles Griffey, TIEC Ex. 4 at 8, 38, 45.

54 Rebuttal Testimony of Thomas P. Brice, SWEPCO Ex. 66 at 5.

55 ICF International is a well-respected firm that provides energy consulting (as well as other) services. It is headquartered in Virginia, and it has offices in both Texas and Louisiana. ICF has vast experience in energy markets and analyzing resource options such as the ones posed by the responses to SWEPCO's RFP. Direct Testimony of Thomas P. Brice, SWEPCO Ex. 26 at 53.

56 Direct Testimony of Thomas P. Brice, SWEPCO Ex. 26 at 53-57, Rebuttal Testimony of Thomas P. Brice, SWEPCO Ex. 66 at 12-14.

57 Direct Testimony of Thomas P. Brice, SWEPCO Ex. 26 at 53.

58 Direct Testimony of Thomas P. Brice, SWEPCO Ex. 26 at 53.

59 Direct Testimony of Thomas P. Brice, SWEPCO Ex. 26 at 55.

60 Direct Testimony of Thomas P. Brice, SWEPCO Ex. 26 at 55.

61 Direct Testimony of Thomas P. Brice, SWEPCO Ex. 26 at 55.

further confirmed that the mixed capacity portfolio, which included the Turk Plant, was the most effective plan for ratepayers.[62]

Finally, in 2009 – after construction began – the LPSC asked the Company to update the original 2007 ICF report to ensure that the Turk plant was still a cost effective option for satisfying SWEPCO's baseload resource requirement.[63] The LPSC staff required the report for purposes of verifying the reasonableness of the Turk choice before recommending that the LPSC approve CWIP recovery for the plant.[64] Like the prior reports, the 2009 ICF report also demonstrated that the Turk Plant was the right choice for SWEPCO and its customers.[65] Based on this report, the LPSC approved the CWIP recovery in January 2010, just six months before Mr. Griffey claims any reasonable utility manager would have cancelled Turk.[66]

After the 2009 ICF study, SWEPCO continued to analyze the facts and circumstances surrounding the continued construction of the Turk plant. However, once the uncommitted costs associated with completing the Turk Plant were less than the cost of a NGCC plant, there was no further need to run economic modeling.[67]

ii. Market-valuation models

Despite insisting that SWEPCO did not analyze the Turk Plant's continued viability after receiving a CCN, Mr. Griffey inconsistently argues that a June 2010 report prepared by AEP personnel demonstrates that the cost-to-complete the plant exceeded its then-market value.[68] Accordingly, Mr. Griffey argues that a reasonable utility manager would have canceled the plant

---

62 Direct Testimony of Thomas P. Brice, SWEPCO Ex. 26 at 56.

63 Direct Testimony of Thomas P. Brice, SWEPCO Ex. 26 at 56.

64 Rebuttal Testimony of Thomas P. Brice, SWEPCO Ex. 66 at 12.

65 Direct Testimony of Thomas P. Brice, SWEPCO Ex. 26 at 56-57.

66 Direct Testimony of Thomas P. Brice, SWEPCO Ex. 26 at 57. After the close of the record, the LPSC approved the Company's Formula Rate Plan extension. Pursuant to the approval, the Company implemented new rates – starting with the first billing cycle of March – that included the Turk plant. The rates were based on a 2011 test year with post-test-year-adjustments for the Turk Plant investment, O&M, and taxes. SWEPCO will provide a copy of the LPSC's order when it is issued.

67 Rebuttal Testimony of Thomas P. Brice, SWEPCO Ex. 66 at 14.

68 Mr. Griffey attached excerpts of the June 1, 2010 Turk draft presentation as Confidential Exhibit CSG-5 to his testimony. The entire presentation is attached as Confidential Exhibit MDF-2R to SWEPCO witness Matthew Fransen's rebuttal testimony.

at this time, thereby saving SWEPCO all of the estimated costs of completing the plant.[69] His opinion necessarily implies that not only SWEPCO, but also its Turk co-owners East Texas Electric Cooperative, Arkansas Electric Cooperative Corp., and Oklahoma Municipal Power Authority, as well as the LPSC, which approved CWIP payments the same year, were all imprudent. Apparently, Mr. Griffey believes none of these utility managers were acting reasonably in 2010. Mr. Griffey, however, misinterprets and misuses the June 2010 analysis. And he completely ignores the impact of committed costs, as well as other costs associated with canceling the plant.[70]

The June 2010 presentation was prepared to inform AEP's Board of Directors of the risk to shareholders due to the loss of the Arkansas CECPN and consequent potential merchant valuation of the 88 MW of Arkansas jurisdictional capacity.[71] The document presented several plant valuations depending on operating scenarios for whether certain jurisdictional ownership shares would remain cost-based service models or be left to compete in the wholesale market.[72] It is simply wrong to assume – as Mr. Griffey does – that the entire plant should be valued on a merchant basis.

The Turk Plant was planned, presented, and certificated by three state regulatory bodies as a baseload unit to provide long-term fuel diversity and price stability to SWEPCO's customers.[73] Consequently, Mr. Griffey's apples to oranges analysis adds no value to a determination of whether SWEPCO's decision to complete the Turk Plant in June 2010 was prudent. Even Mr. Griffey concedes that his "market" valuation methodology results in the "value" of Turk changing multiple times every day, every time gas futures quotations change.[74]

---

[69] OPUC witness Karl Nalepa also argues that the declining merchant-value of the plant supported cancellation of the plant in June 2010. *See* Redacted Direct Testimony of Karl Nalepa, OPUC Ex. 1 at 23-24.

[70] Rebuttal Testimony of Thomas P. Brice, SWEPCO Ex. 66 at 8-9 (describing additional costs associated with canceling the plant).

[71] Rebuttal Testimony of Matthew D. Fransen, SWEPCO Ex. 69 at 9.

[72] Rebuttal Testimony of Matthew D. Fransen, SWEPCO Ex. 69 at 9.

[73] Rebuttal Testimony of Thomas P. Brice, SWEPCO Ex. 66 at 7.

[74] Tr. at 1439-1440.

He gave no precedent for any regulator or reasonable utility manager using such a mercurial methodology to value a regulated plant intended to be in service for decades.[75]

Even assuming Mr. Griffey's merchant comparison were valid, simple math still supports SWEPCO's decision to complete the plant in June 2010. Mr. Griffey implies that the Turk Plant's owners would have saved by halting construction and ceasing all payments. This is wrong. It ignores the fact that up to $450 million of additional costs could not have been avoided because the owners were already obligated to pay them.

Mr. Griffey's failure to account for the committed costs must be presumed to be intentional because their existence was made known to him in at least three different documents. The committed costs were expressly referenced on page 8 of the June 2010 analysis Mr. Griffey relies on as the basis for his opinion that cancellation was appropriate.[76] The committed costs are also identified at the bottom of page 0015 of Confidential Exhibit CSG-2 to Mr. Griffey's testimony.[77] Finally, SWEPCO unambiguously stated in response to TIEC's Thirteenth Request for Information, Question No. 13-8, that "[i]f the question is asking if the cancellation costs are in the Estimated Costs to Complete, the answer is yes."[78] As Mr. Griffey noted during the hearing, cancellation costs are a subset of committed costs that represent AEP's estimate of the minimum amount it would take to cancel the plant.[79] Properly accounting for the committed costs would have more than eliminated the alleged benefit to SWEPCO of cancelling the plant.[80] Mr. Griffey's purported excess of cost-to-complete over "market" value becomes a valuation of greater than the cost-to-complete.

Even if bare cancellation costs (estimated at $120 million[81]) are substituted for the committed costs, the supposed benefit of cancellation disappears, and Turk's "merchant" value would still exceed its cost-to-complete by over . And Mr. Griffey conceded that a

---

75 Tr. at 1391 (Mr. Griffey concedes that he is unaware of any case in which the Commission has used a market-based model like the one he proposes in this case).

76 *See* Rebuttal Testimony of Matthew D. Fransen, SWEPCO Ex. 69, Exhibit MDF-2R at 8.

77 Confidential Exhibits to the Direct Testimony of Charles Griffey, TIEC Ex. 4B, Confidential Exhibit CSG-2 at 82.

78 *See* Redacted Direct Testimony of Charles Griffey, TIEC Ex. 4 at Exhibit CSG-2 at 82.

79 Tr. at 1431.

80 Rebuttal Testimony of Matthew D. Fransen, SWEPCO Ex. 69 at 10.

81 Rebuttal Testimony of Matthew D. Fransen, SWEPCO Ex. 69, Exhibit MDF-2R at 8.

reasonable utility manager might determine actual cancellation would take some number in between AEP's cancellation cost estimate and the full amount of the contractual committed costs.[82] Mr. Griffey also fails to factor in any cost for SWEPCO's need to procure sufficient energy to replace the Turk capacity, which would also have offset any cancellation savings.[83]

In order to increase the purported savings associated with canceling the Turk Plant and have his analysis superficially appear to make sense, Mr. Griffey makes several unreasonable "adjustments" to the June 2010 analysis.[84] For example, he adds to the cost-to-complete estimate the "transmission to go costs," and also makes adjustments for what is referred to as the "2H'10 Reference Forecast" and the cost of "Other Settlement Items."[85] These results-oriented "adjustments" should be ignored.

First, it is unreasonable to assume that cancelling the Turk Plant would save SWEPCO the transmission costs. The transmission assets would still be required for any new plant built at the Turk site. Second, Mr. Griffey concludes that if AEP had used the "2H'10 Reference Forecast" the Turk Plant market valuation would have declined by , tilting the scales in favor of cancellation. But Mr. Griffey readily concedes that he does not know if the "2H'10 Reference Forecast" was available in June 2010.[86] And he admits that information not known at the time a decision is made is irrelevant to an assessment of whether the decision was prudent.[87] Finally, the "Other Settlement Items" adjustment – which assumes cancellation in June 2010 would save SWEPCO the entire cost of settlements reached in 2011 – is similarly irrelevant to the prudence analysis. Mr. Griffey offers no explanation of how a reasonable utility manager in 2010 would have known the dollar amount of savings possible from avoiding the need to settle litigation more than a year in the future or the risks imposed by an injunction that had yet to be entered.

---

82 Confidential Tr. at 1410-11; 1445-46.

83 Rebuttal Testimony of Thomas P. Brice, SWEPCO Ex. 66 at 8-9; Rebuttal Testimony of Matthew D. Fransen, SWEPCO Ex. 69 at 10-11.

84 Revised Highly Sensitive Direct Testimony of Charles Griffey, TIEC Ex. 4A at 54-56.

85 Revised Highly Sensitive Direct Testimony of Charles Griffey, TIEC Ex. 4A at 54-56.

86 Revised Highly Sensitive Direct Testimony of Charles Griffey, TIEC Ex. 4A at 54-55, n. 84.

87 Redacted Direct Testimony of Charles Griffey, TIEC Ex. 4 at 8, 58-59; Tr. at 1377.

Ultimately, the value of the Turk Plant in June 2010 is most appropriately viewed as the sum of its parts – i.e., the merchant value of the 88 MW Arkansas jurisdictional share[88] + the regulated/cost-based recovery value of 352 MW (the remainder of SWEPCO's share).[89] This equates to in value as compared to an approximately cost to complete the plant at that time. Clearly, given this information, completing the plant is within the range of decisions a reasonable utility manager would make in June 2010.

iii. Gas price volatility

Mr. Griffey asserts that the 2009 ICF report showed that the Turk Plant was less economic than a combined cycle gas turbine when the real levelized price of gas was less than $6.58/MMBtu.[90] He then cites spot prices and NYMEX futures prices for gas in 2008 and 2009 and notes that by the end of 2009 gas futures prices had fallen below the break-even gas price level for the plant.[91] The implication is that the purported downward trend in gas futures prices was an indication of future gas prices, which would continually erode the economic basis for the plant.[92] Mr. Griffey's reliance on gas futures prices, however, is unreasonable; particularly so, given his testimony that all things change and that you cannot expect actual prices to be the same as futures projections.[93] TIEC witness Jeffry Pollock also testifies that actual prices end up being the same as projections only by sheer coincidence.[94]

SWEPCO witness Karl Bletzacker[95] explains that NYMEX natural gas futures pricing is not intended to be a reliable forecast of long-term future, weather-normalized, natural gas price fundamentals.[96] He further explains why it would have been unreasonable to cancel the Turk Plant when spot or NYMEX futures prices dipped below the break-even price identified in the

---

88 Ms. McCellon-Allen noted at the hearing that SWEPCO's current plan is to seek inclusion of the Company's 88 MW Arkansas jurisdictional share in Arkansas retail rates later this year. Tr. at 105-06.

89 Rebuttal Testimony of Matthew D. Fransen, SWEPCO Ex. 69 at 10.

90 Revised Highly Sensitive Direct Testimony of Charles Griffey, TIEC Ex. 4A at 40.

91 Revised Highly Sensitive Direct Testimony of Charles Griffey, TIEC Ex. 4A at 40-42.

92 Revised Highly Sensitive Direct Testimony of Charles Griffey, TIEC Ex. 4A at 40-42.

93 Tr. at 1374, 1386

94 *See, e.g.,* Cross-Rebuttal Testimony of Jeffry Pollock, TIEC Ex. 2, Appendix D at 27.

95 Karl Bletzacker is the Director of Fundamental Analysis for AEPSC. Mr. Bletzacker is AEP's expert on the fundamentals surrounding the global and national natural gas markets, and has operated in the natural gas industry for years. Rebuttal Testimony of Venita McCellon-Allen, SWEPCO Ex. 65 at 21-22; Rebuttal Testimony of Karl R. Bletzacker, SWEPCO Ex. 68 at 3-4.

96 Rebuttal Testimony of Karl R. Bletzacker, SWEPCO Ex. 68 at 5.

2009 ICF analysis.[97] In addition, Mr. Bletzacker testifies that low near-term spot gas prices are not an indication that future prices will remain low.[98] To the contrary, Mr. Bletzacker demonstrates that near-term natural gas prices are and will remain volatile as they are primarily affected by weather's departure from normal, which then results in deficit or surplus levels of natural gas storage inventory.[99] And he confirms the uncontested point that natural gas spot prices have historically been more volatile than delivered coal prices.[100]

iv. SWEPCO's capacity resource need

OPUC witness Karl Nalepa contends that the Company's capacity margin forecasts since its CCN proceeding have shown that the Company would exceed its target 12-percent reserve margins, even without the Turk plant.[101] Mr. Nalepa insists that SWEPCO refused to recognize this change in need.[102] As a result, he argues that SWEPCO should have taken the opportunity to cancel the plant in June 2010 when it should have known that it no longer needed the capacity.[103] But Mr. Nalepa's position is based on the unreasonable and false assumption that Welsh Unit 2 will continue operating beyond 2016.[104]

SWEPCO witness Scott Weaver notes multiple errors in Mr. Nalepa's calculations, which include the double counting of the Welsh Unit 2 capacity.[105] More importantly, Mr. Weaver shows that the capacity margins calculated in Mr. Nalepa's revised forecasts – even setting aside the calculation errors – would not be considered excessive based on PUCT precedent.[106] Accordingly, canceling the Turk Plant based on Mr. Nalepa's revised forecasts would have been unreasonable.

---

97 Rebuttal Testimony of Karl R. Bletzacker, SWEPCO Ex. 68 at 6.

98 Rebuttal Testimony of Karl R. Bletzacker, SWEPCO Ex. 68 at 6-7.

99 Rebuttal Testimony of Karl R. Bletzacker, SWEPCO Ex. 68 at 7.

100 Rebuttal Testimony of Karl R. Bletzacker, SWEPCO Ex. 68 at 7.

101 Redacted Direct Testimony of Karl Nalepa, OPUC Ex. 1 at 21.

102 Redacted Direct Testimony of Karl Nalepa, OPUC Ex. 1 at 22-23.

103 Redacted Direct Testimony of Karl Nalepa, OPUC Ex. 1 at 23-24.

104 Redacted Direct Testimony of Karl Nalepa, OPUC Ex. 1 at 21-22 (explaining that he revised the Company's CDR forecasts to remove the projected Turk capacity and reinstating the existing Welsh Unit 2 capacity); *see also* Rebuttal Testimony of Scott C. Weaver, SWEPCO Ex. 67 at 4-5.

105 Rebuttal Testimony of Scott C. Weaver, SWEPCO Ex. 67 at 5.

106 Rebuttal Testimony of Scott C. Weaver, SWEPCO Ex. 67 at 6-11 (citing several specific examples).

c. Overall Prudence

SWEPCO's decision to complete the Turk Plant in June 2010 in the wake of the Arkansas Supreme Court's reversal of the APSC's order granting SWEPCO a CECPN for the plant was prudent. At that point in time, SWEPCO's management was aware of the following facts:

- SWEPCO had received CCNs in Texas and Louisiana that authorized construction for native load customers in those states;
- engineering for the plant was already 93% complete and overall plant construction was 39% complete;[107]
- the uncommitted costs associated with completing the Turk Plant were less than the cost of a NGCC plant;[108]
- SWEPCO could proceed with construction and operation of the Turk Plant in accordance with the exemption set forth in ARK. CODE ANN. § 23-18-504(a)(5), by simply stating that the Company was not going to seek recovery of costs of the Turk Plant in retail rates subject to regulation by the APSC;[109]
- the combined estimated value of SWEPCO's regulated and unregulated shares of the Turk Plant exceeded the cost-to-complete by ;[110]
- SWEPCO needed the capacity provided by the Turk Plant to meet the needs of its native load customers, which includes wholesale customers;[111]
- the LPSC had reaffirmed its support for the Turk Plant by approving CWIP recovery in January 2010;[112]
- the co-owners of the Turk Plant were depending on the plant's completion; and,
- natural gas prices have historically been more volatile than coal and there was no indication that the relative price stability of the two fuels would materially change from that historically experienced.[113]

---

[107] Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 at 42.

[108] Rebuttal Testimony of Thomas P. Brice, SWEPCO Ex. 66 at 12.

[109] Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 at 41-42.

[110] Confidential Rebuttal Testimony of Matthew D. Fransen, SWEPCO Ex. 69A at 10.

[111] Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 at 42.

[112] Rebuttal Testimony of Thomas P. Brice, SWEPCO Ex. No. 66 at 5.

Given these facts, it is difficult to argue that deciding to complete the Turk Plant was not within the range of options that a reasonable utility manager would choose under the same or similar circumstances.[114] Moreover, completing the plant was in line with SWEPCO's fundamental strategy of maintaining fuel diversity to hedge against future volatility in fuel commodity prices.[115] This highly successful strategy has helped SWEPCO keep its rates lower than all non-ERCOT utilities in Texas.[116] Ultimately, proceeding with the Turk Plant under the Arkansas statutory exemption was the most reasonable and economical decision for SWEPCO and its customers in Texas and Louisiana, as well as its wholesale customers in three states.[117]

Mr. Griffey's and Mr. Nalepa's market-based valuations should be discarded entirely. Neither witness produced a single example of a case in which the Commission has relied on this approach for valuing generation plants. And Mr. Griffey acknowledged that the approach is contrary to traditional cost-of-service ratemaking.[118] Essentially, the witnesses are arguing for a retreat to a fair-value rate base, which was rejected by the legislature when it amended what is now PURA § 36.053 in 1983.[119]

Finally, Mr. Griffey's argument concerning the relative disparity between rates in Texas and Arkansas is not relevant to any issue in this case. Mr. Griffey admitted that rates vary from utility to utility and from state to state.[120] And he admitted that rates in Texas have nothing to do with rates in Arkansas.[121] Ultimately, any differences between Texas and Arkansas rates have nothing to do with whether SWEPCO's decision to complete the Turk Plant in 2010 was prudent.

---

[113] Rebuttal Testimony of Karl R. Bletzacker, SWEPCO Ex. 68 at 7-8.

[114] The traditional prudence standard is set out in Ms. McCellon-Allen's direct testimony. Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 at 34. Mr. Griffey's prudence opinions rely on this standard. Redacted Direct Testimony of Charles Griffey, TIEC Ex. 4 at 58-59.

[115] Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 at 42.

[116] Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 at 21-23.

[117] Rebuttal Testimony of Venita McCellon-Allen, SWEPCO Ex. 65 at 21; Tr. at 105-06 (noting SWEPCO's plan to pursue inclusion of the Arkansas share of the plant in retail rates later this year).

[118] Tr. at 1390-92.

[119] Acts 1983, 68th Leg., R.S.,ch. 274 (SB 232), § 1, General and Special Laws of Texas.

[120] Tr. at 1379.

[121] Tr. at 1380.

3. Turk Litigation and Settlement Costs [PO Issue 9]

a. Background of Turk Litigation

There were significant legal challenges to the construction of the Turk Plant. In 2010, the Sierra Club, National Audubon Society, the Hempstead County Hunting Club (HCHC), and a number of individuals affiliated with one or more of these groups, filed separate complaints – one headed up by HCHC and the other by the Sierra Club – with the federal district court in the Western District of Arkansas against the U.S. Army Corps of Engineers, the U.S. Department of Interior, and the U.S. Fish and Wildlife Service.[122] The lawsuits challenged the Corps' issuance of permits for the Turk Plant that authorized SWEPCO to fill wetlands and to construct the water intake structure and six river crossings for transmission lines, and sought to enjoin construction of the Turk Plant.[123] SWEPCO intervened to protect its interests, and the two lawsuits were consolidated for the temporary injunction hearing.[124] In the last quarter of 2010, the Sierra Club and HCHC litigants obtained a temporary injunction stopping the activities authorized by the Corps, and the U.S. Court of Appeals for the Eighth Circuit upheld that injunction, concluding, among other things, that the plaintiffs had shown a likelihood of success.[125]

As long as the injunction was in place, SWEPCO could not complete the three transmission lines necessary to deliver the full electrical output to the grid and the water intake structure designed to supply cooling water to the Turk Plant.[126] The Turk Plant could not operate at full capacity until the transmission lines and the water intake structure were completed.[127]

Additionally, some of the same plaintiffs asserted in their federal court suit that SWEPCO could not build Turk under the Arkansas statutory exemption after the reversal of its CECPN by that state's Supreme Court.[128] By early 2011 it became clear to SWEPCO and AEP management that continuation of the existing lawsuits through various courts could impair SWEPCO's ability to construct the final components necessary to operate the plant in a cost

---

[122] Direct Testimony of Jeffrey Civins, SWEPCO Ex. 30 at 11.

[123] Direct Testimony of Jeffrey Civins, SWEPCO Ex. 30 at 11.

[124] Direct Testimony of Jeffrey Civins, SWEPCO Ex. 30 at 11.

[125] Direct Testimony of Jeffrey Civins, SWEPCO Ex. 30 at 11.

[126] Direct Testimony of Jeffrey Civins, SWEPCO Ex. 30 at 12.

[127] Direct Testimony of Jeffrey Civins, SWEPCO Ex. 30 at 12.

[128] Direct Testimony of Jeffrey Civins, SWEPCO Ex. 30 at 11.

effective manner.[129] Given the commitment and funding of both plaintiff groups, the legal attacks on Turk were unlikely to abate.[130] Having achieved a victory in the Arkansas Supreme Court, which decided on questions certified by the federal court that the plaintiffs had to pursue their claims regarding the statutory exemption before the APSC, and a victory in the legislature, which clarified SWEPCO's right to construct under the exemption, SWEPCO determined that the time was ripe for settlement discussions.[131] In May 2011, SWEPCO reached a settlement with HCHC and the individual plaintiffs, and in December 2011, the Company reached a settlement with the Sierra Club plaintiffs.[132] In the settlements SWEPCO agreed to a cash payment and made several commitments regarding its future actions.[133] The plaintiffs agreed to withdraw all legal challenges to the Turk Plant's construction and operation, which allowed the plant to be completed and come on-line in December 2012.[134]

SWEPCO's decision to settle the lawsuits allowed the plant to continue on schedule without the threat of further expensive and time-consuming litigation.[135] The settlement amounts, which SWEPCO has capitalized as a cost to build the plant, were within the "contingency" percentage allowed for in the plant construction budget, and did not result in an increase to the overall plant budget.[136] Moreover, the settlements' money costs were ameliorated by other considerations.[137] For example, in the Sierra Club settlement SWEPCO agreed that, once the Turk plant began commercial operation, Welsh Unit 2 would be limited to no more than 60% of its annual capacity (down from its historical capacity factor of some 80%), and that AEP would seek regulatory approval to retire Welsh Unit 2 no later than December 31, 2014 (or 2016

---

[129] Rebuttal Testimony of Venita McCellon-Allen, SWEPCO Ex. 65 at 10.

[130] Rebuttal Testimony of Venita McCellon-Allen, SWEPCO Ex. 65 at 11.

[131] Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 at 36.

[132] Rebuttal Testimony of Venita McCellon-Allen, SWEPCO Ex. 65 at 10.

[133] The exact details of the settlements are set out in the Direct Testimony of Company witness Jeff Civins. *See* Highly Sensitive Exhibit C to the Direct Testimony of Jeffrey Civins, SWEPCO Ex. 30A (table of all settlement considerations).

[134] Direct Testimony of Jeffrey Civins, SWEPCO Ex. 30 at 12; Rebuttal Testimony of Venita McCellon-Allen, SWEPCO Ex. 65 at 10.

[135] Rebuttal Testimony of Venita McCellon-Allen, SWEPCO Ex. 65 at 11.

[136] Rebuttal Testimony of Venita McCellon-Allen, SWEPCO Ex. 65 at 11.

[137] Direct Testimony of Jeffrey Civins, SWEPCO Ex. 30 at 15-16.

if additional time is needed to complete transmission mitigation work).[138] However, SWEPCO had previously committed to limit capacity at the Welsh Unit 2 as a condition to receipt of its air permit for the Turk Plant. And AEP had already announced its intent to retire the unit.[139] With regard to Welsh Unit 2, SWEPCO agreed to do what it already planned to do, achieving benefits for ratepayers at no additional cost. This was shrewd negotiation that benefited all concerned. Nevertheless, intervenors complain.

b. Prudence of settlements

TIEC, CARD, Cities, and OPUC witnesses each propose disallowance of the settlements under the following theories:

- TIEC witness Jeffry Pollock opines that the settlement costs were only incurred for the benefit of SWEPCO's shareholder – AEP – and that recovery of the expenses is "inconsistent" with the Turk cost cap.[140]
- CARD witness Scott Norwood argues that the (a) Company did not provide sufficient quantification of the costs or the potential benefits resulting from the settlements; (b) additional cost of potential delays in the construction of the Turk plant would have exceeded SWEPCO's cost cap and thus should not be borne by ratepayers; and (c) the Company failed to justify its agreement to limit and subsequently retire Welsh Unit 2.[141]
- Cities witness Constance Cannady contends that the expenses should be disallowed because they were due to the Company's actions and not those of its customers.[142]
- OPUC witness Karl Nalepa maintains that the settlement expenses do not benefit customers and that the agreement to retire Welsh Unit 2 was unreasonable.[143]

None of these theories withstands examination.

SWEPCO plainly quantified the costs and explained the risks associated with not settling the lawsuits. Ms. McCellon-Allen quantified a minimum cost of delay, using a calculation of the

---

[138] Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 at 33.

[139] Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 at 38-39.

[140] Redacted Direct Testimony of Jeffry Pollock, TIEC Ex. 1 at 32-33.

[141] Redacted Direct Testimony of Scott Norwood, CARD Ex. 4 at 6, 12.

[142] Redacted Direct Testimony of Constance Cannady, Cities Ex. 2 at 9.

[143] Redacted Direct Testimony of Karl Nalepa, OPUC Ex. 1 at 30-31.

Allowance for Funds Used During Construction (AFUDC), that would continue to accrue to the cost of Turk each month beyond the date that Turk could otherwise have been completed.[144] This calculation results in about $10 million added to the cost of the plant for each month of delay.[145] The AFUDC calculation is prescribed by the Federal Energy Regulatory Commission (FERC) and is a known and accepted calculation performed monthly by every FERC-regulated utility, so it cannot be argued that this calculation is not a reasonable quantification of delay costs.[146] Moreover, because AFUDC is not included in the Turk cost cap, these delay costs would be borne by customers.[147] The sum calculated by Ms. McCellon-Allen also does not include additional costs associated with matters such as mobilizing and demobilizing construction crews, modifying construction schedules, and the potential loss of the favorable engineering, procurement and construction contract.[148]

SWEPCO witness Jeff Civins also clearly testified to the risks and costs to SWEPCO had it not settled the case.[149] For instance, he explained that absent the settlement there was a significant risk, given the 8th Circuit's conclusion that the plaintiffs had shown a likelihood of success, that the Corps permit would be revoked.[150] Revocation of the Corps permit would have re-triggered the National Environmental Policy Act (NEPA) process, which could have delayed permitting by eighteen months or more.[151]

The argument that cost overruns should not matter because under the cost cap customers would not pay for future delays goes against any reasonable business-person's obligation in decision-making, which is to attempt to make the right decisions and avoid unnecessary costs.[152] It also ignores the fact that AFUDC costs are not subject to the cost cap.[153] And it completely

---

[144] Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 at 36; Rebuttal Testimony of Venita McCellon-Allen, SWEPCO Ex. 65 at 12-13.

[145] Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 at 36; Rebuttal Testimony of Venita McCellon-Allen, SWEPCO Ex. 65 at 12-13.

[146] Rebuttal Testimony of Venita McCellon-Allen, SWEPCO Ex. 65 at 13.

[147] Rebuttal Testimony of Venita McCellon-Allen, SWEPCO Ex. 65 at 12.

[148] Direct Testimony of Jeffrey Civins, SWEPCO Ex. 30 at 13.

[149] Direct Testimony of Jeffrey Civins, SWEPCO Ex. 30 at 13.

[150] Direct Testimony of Jeffrey Civins, SWEPCO Ex. 30 at 13.

[151] Direct Testimony of Jeffrey Civins, SWEPCO Ex. 30 at 13.

[152] Rebuttal Testimony of Venita McCellon-Allen, SWEPCO Ex. 65 at 13.

[153] Rebuttal Testimony of Venita McCellon-Allen, SWEPCO Ex. 65 at 12.

disregards the fact that SWEPCO had obligations to its Louisiana, Texas and FERC customers with respect to completing the construction of the Turk plant, and would be further scrutinized by regulatory commissions on whether the project was prudently managed.[154] Imagine the outcry that would be heard from intervenors if SWEPCO had not settled these claims, but had litigated them for another two years to a completely successful conclusion, resulting in another quarter billion dollars in AFUDC. Settlement was clearly the prudent course.

It is also untrue that but for the Turk Plant AEP would not have decided to initially limit and subsequently retire Welsh Unit 2. To the contrary, the disposition of Welsh Unit 2 was the result of factors unrelated to the Sierra Club settlement.[155] First, early in the Turk Plant permitting process, Welsh Unit 2, which is uncontrolled for SO_2, was identified as a potential source of impacts on visibility in nearby federal lands.[156] Thus, as a condition of the Turk Air Permit, SWEPCO agreed to limit SO_2 emissions from Welsh Unit 2 after Turk is in service, either through reduced utilization or additional controls.[157] This was no concession at all, because SWEPCO already knew it would have to take remedial action at all the uncontrolled Welsh units.[158]

The future of all three SO_2 uncontrolled Welsh units was already in question because of proposed Environmental Protection Agency (EPA) regulations, which were finalized in 2011 and 2012, together with expected future regulations.[159] SWEPCO evaluated its options and developed an environmental compliance plan for its solid fuel fleet that included upgrading or installing advanced emissions reduction equipment at Flint Creek, Pirkey, the Dolet Hills Units, and Welsh Units 1 and 3 at a cost of more than $1 billion.[160] As for Welsh Unit 2, SWEPCO could either spend another $529 million on emission controls or curtail output to a sixty percent capacity factor until 2014, and then retire the unit.[161] Incurring the $529 million was not

---

[154] Rebuttal Testimony of Venita McCellon-Allen, SWEPCO Ex. 65 at 13.

[155] Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 Direct at 38.

[156] Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 at 38.

[157] Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 at 38.

[158] Rebuttal Testimony of John C. Hendricks, SWEPCO Ex. 70 at 5-7.

[159] Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 at 38.

[160] Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 at 38.

[161] Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 at 39.

financially feasible.[162] A June 9, 2011 AEP press release announced the decision to retire Unit 2 in late 2014.[163] Consequently, the agreement with the Sierra Club regarding Welsh Unit 2 simply confirmed what AEP and SWEPCO had already determined to do six months earlier. The concession cost SWEPCO nothing, and gained it and its customers a settlement of potentially harmful litigation.

Finally, the claims that the settlements are inconsistent with the cost cap and that they do not benefit customers make no sense. As noted previously, SWEPCO's test year-ending cumulative Turk expenditures, which include the settlement costs, are less than the Company's jurisdictional share of the Commission-approved cost cap.[164] Furthermore, it should be clear that everyone – SWEPCO, its shareholder, and its customers – benefited from the timely completion of the Turk Plant. Customers benefit from the cleanest, most efficient coal plant in the United States. The settlements also minimized AFUDC. Likewise, Ms. Cannady's theory makes no sense. Of course the suits were the results of SWEPCO's (and, more particularly, the plaintiffs') actions instead of ratepayers'. Everything about Turk, Stall, and Mattison was the result of SWEPCO's actions, not ratepayers'. The entire building program to supply customers with reliable, diverse sources of power was undertaken by SWEPCO, with the express approval of three states' regulators, on behalf of its ratepayers. Those ratepayers are responsible for the prudent costs incurred in the program, and those prudent costs include the environmental litigation settlements.

SWEPCO acted prudently in resolving the regulatory and legal challenges to the construction and operation of the Turk Plant. Those challenges had resulted, and would continue to result, in delay and an inability to use the full plant capacity to provide power to customers. In addition to the approximately $10 million in costs per month for construction delays, SWEPCO also was incurring significant litigation costs. In settling, SWEPCO eliminated the uncertainty of success and the ongoing costs associated with delay and cleared a path for its future use of the planned capacity of the Turk Plant to serve its customers. This was obviously the right thing to do.

---

[162] Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 at 39.

[163] *See* SWEPCO Ex. No. 89.

[164] Mr. Norwood agreed at the hearing that the settlement costs are included in the balance SWEPCO seeks to include in rate base in this case and that the balance is less than the Texas jurisdictional amount of the cap. Tr. at 995.

4. Post-Test Year Adjustment [PO Issues 16, 31]

SWEPCO is using a post-test year adjustment to include investment in the Turk plant in rates. This rate treatment is authorized by P.U.C. SUBST. R. 25.231(c)(2)(F). This rule allows post-test year adjustments for known and measurable rate base additions to historical test year data provided certain criteria are met. This rate treatment is reserved for additions that constitute at least 10% of the utility's requested rate base. The magnitude of SWEPCO's investment in the Turk plant far outstrips this requirement and represents an increase of approximately 35% to SWEPCO's net plant at December 31, 2011. The post-test year adjustment rule further requires that the plant addition be deemed by the Commission to be in service before the rate year begins. In essence, so long as the plant begins to provide service to customers before the new rates are initiated, SWEPCO's new rates may include recovery of Turk plant costs. As discussed next, that criterion has been satisfied.

a. Turk In-Service Date

Turk entered service on December 20, 2012. From then through January 6, 2013, Turk generated approximately 226,864 net megawatt-hours (MWh) of electricity for SWEPCO's customers, which equates to a capacity factor of 90%.[165] Turk entered service by meeting the three in-service criteria laid out in Mr. Beam's direct testimony.[166]

1. In accordance with SWEPCO's Southwest Power Pool (SPP) Interconnection Agreement, SWEPCO's Mr. Franklin (Vice President - Generating Assets) sent a letter to the SPP's Chief Executive Office 24 hours prior to the commercial operation of the plant. This step was performed on December 19, 2012.
2. SWEPCO and AEP Commercial Operations then revised the resource commitment provided to the SPP, officially showing the time that Turk would be declared commercially operational. This second step was performed on December 20, 2012.
3. Turk control room operators called system dispatchers in AEP Commercial Operations and declared that Turk was commercially operational and ready for dispatch. This step, finalizing Turk's commercial operation, was performed on December 20, 2012.[167]

---

[165] Rebuttal Testimony of Paul W. Franklin, SWEPCO Ex. 71 at 6.

[166] Direct Testimony of Christian T. Beam, SWEPCO Ex. 28 at 89-90.

[167] Rebuttal Testimony of Paul W. Franklin, SWEPCO Ex. 71 at 7.

Turk has not only entered service, it has exceeded great expectations in both efficiency (heat rate) and capacity. It has operated at an enviable heat rate of approximately 8,600-8,700, making it the jewel in the crown of SWEPCO's solid fuel generating fleet.[168] Turk has the second lowest heat rate of ALL of SWEPCO's generating units, second only to the gas-fired, combined cycle Stall plant. The closest heat rate among the other solid fuel units was 10,298 (Welsh 3).[169]

Turk is also producing more megawatts than anticipated. Although it is nominally rated at 600 MW, it has produced in the 650-670 MW range, raising the possibility that customers will reap the benefit of more capacity.[170]

OPUC witness Mr. Nalepa proposed to disallow all Turk capital and other costs on the grounds that Turk was not used and useful. One rationale for his used and useful argument was that Turk had not entered service. He admitted at hearing, however, that this rationale (offered in his testimony filed before Turk entered service) no longer holds true.[171]

In conclusion, Turk has entered service as a valuable asset for SWEPCO and customers and has met the requirements for inclusion in rate base.

b. Transmission Investment and CWIP

SWEPCO properly included transmission invested capital as an attendant impact of the Turk Power Plant post-test year adjustment. The Commission's rule on post-test year rate base additions calls for the identification, quantification, and matching of the post-test year rate base addition with its "attendant impacts on all aspects of a utility's operations," including, but not limited to, invested capital. Attendant impacts are defined as those that "reasonably follow as a consequence" of the post-test year adjustment.[172]

It cannot be debated that the Turk transmission invested capital is an element of invested capital. It cannot be reasonably debated that the Turk transmission invested capital "reasonably follows as a consequence" of the Turk plant. The Turk transmission projects would not have

---

[168] Tr. at 76-77.

[169] Direct Testimony of Russell A. Gedeon, SWEPCO Ex. 63 at Exhibit RAG-3. Although Turk's heat rate is higher than Stall's, Turk can take advantage of the fact that coal prices are lower than gas prices. Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 at 44.

[170] Tr. at 98.

[171] Tr. at 1164-1165.

[172] P.U.C. SUBST. R. 25.231(c)(2)(F)(i)(IV).

been required if there were no Turk plant and are physically necessary for the delivery of energy from the Turk plant. The SPP Regional Transmission Organization has the responsibility to determine the necessary lines and upgrades needed to support the addition of the new Turk plant, as well as maintain the reliability of the transmission grid. SPP approved the required transmission projects needed for the Turk plant. The Turk plant would not be able to connect to the transmission grid, generate at full output, and serve SWEPCO customers, including Texas customers, without the new transmission lines and upgrades to existing lines and infrastructure. The transmission line and upgrade projects associated with the Turk plant are now complete and are in service.[173]

5. Turk land costs [PO Issue 6]

Turk is situated on an approximately 2,875-acre site.[174] Finding of Fact 21 in the Turk CCN order in PUCT Docket No. 33891 recites: "The site was selected because it had the acreage to support multiple units, sufficient raw water and potable water sources, rail access for delivery of the fuel, and an owner who was willing to sell the property."[175] Under the Turk-related litigation settlements that Ms. McCellon-Allen discusses, SWEPCO agreed that it would not build any additional generating units on the Turk site.[176] Cities witness Ms. Cannady proposes that, as a result of this particular agreement, the investment for land at the Turk Plant be reduced by one half.[177] Mr. Franklin points out the two flaws that undermine Ms. Cannady's recommendation.[178]

First, she assumes that land for a power plant is available in any acreage possible—that the amount of land a seller will sell can be ratcheted up or down in increments. But this is not so. When SWEPCO purchased land for Turk, it was necessary to purchase enough land, and entire properties needed to be purchased. SWEPCO was not capable of purchasing only exact fractions of properties that would just meet its needs. In fact, SWEPCO purchased the main

---

[173] Rebuttal Testimony of Charles D. Matthews, SWEPCO Ex. 78 at 4-5.

[174] Rebuttal Testimony of Paul W. Franklin, SWEPCO Ex. 71 at 36.

[175] Docket No. 33891 Order, SWEPCO Ex. 102 at 14.

[176] Direct Testimony of Venita McCellon-Allen, SWEPCO Ex. 25 at 33.

[177] Redacted Direct Testimony of Constance Cannady, Cities Ex. 2 at 14.

[178] Rebuttal Testimony of Paul W. Franklin, SWEPCO Ex. 71 at 36-37.

portion of the property from the Weyerhaeuser Corporation, and it was only available as a single parcel.[179]

Second, Ms. Cannady wrongly assumes that the amount of land necessary for one generating unit at the Turk site would be half the land required for two units. But this assumption is wrong, too. The Turk generating unit itself only occupies a small portion of the overall site. Much other acreage is needed for purposes such as landfills, access to bodies of water, access roads, and other improvements. However, the need for each improvement does not increase proportionally to the number of generating units that are constructed at the site. For instance, if a site has access to water, it is not necessary to double that access to add a second generating unit.[180]

Exhibit PWF-8R to Mr. Franklin's rebuttal testimony is a map of the Turk site on which a hypothetical second generating unit has been superimposed. This map shows that a second generating unit at the Turk site would require approximately 38 acres of space—or roughly just 1.3% of the total land at the Turk site.[181] Thus, even if one were to accept Ms. Cannady's premise that a disallowance is warranted, the amount would be only a fraction of what she recommends.

6. Turk Auxiliary Boiler [PO Issue 6]

The Turk auxiliary boiler serves an important stand-by role—it provides auxiliary steam to the facility when the main boiler is out of service.[182] SWEPCO seeks to include in rate base the costs of two Turk auxiliary boilers. The first is the larger one that is in service at Turk. The second is a smaller one that was built, is not in service, and is for sale.

This subject generated so much time and attention in this case that it is easy to lose sight of the few main facts and their sequence. But Judge Wilfong elicited precisely such information in his clarifying questions to Mr. Franklin.

1. The original design of the auxiliary boiler was predicated on using the larger one.
2. Under further consideration, it was decided that a smaller boiler could be used, with the advantage of lower cost and lower emission rates. This decision was made

---

[179] Rebuttal Testimony of Paul W. Franklin, SWEPCO Ex. 71 at 36.

[180] Rebuttal Testimony of Paul W. Franklin, SWEPCO Ex. 71 at 36-37.

[181] Rebuttal Testimony of Paul W. Franklin, SWEPCO Ex. 71 at 37.

[182] Direct Testimony of Christian T. Beam, SWEPCO Ex. 28 at 83.

possible because of a change in the design associated with the boiler feed pump, which in turn allowed the use of a smaller auxiliary boiler.

3. But later, it was determined that a change to the smaller boiler would cause complications in the Turk air permitting process, already in litigation. So the decision was made to go back to the original plan with the larger boiler.[183]
4. The cost of the larger boiler (the one in service) through the 2011 test-year-end was $14,119,754. An additional $788,091 was incurred in 2012.[184]
5. The smaller boiler's cost (which is confidential) is much less.[185]

SWEPCO seeks to recover the costs of both auxiliary boilers. The main issues revolve around steps 2 and 3 above—the decision to change from the larger to the smaller boiler, and then the later decision to revert to the larger boiler. As explained next, both of these decisions were prudent given the information available at the time and were designed to benefit Turk and SWEPCO's customers.

SWEPCO filed the Turk air permit application with the ADEQ in August 2006.[186] As the detailed design phase progressed, the auxiliary boiler was among the many systems that were modified to optimize the plant design.[187] Specifically, a smaller, more efficient and less expensive auxiliary boiler than the one originally anticipated could be used. The Architect Engineer (Shaw) submitted the construction plans using the smaller boiler, which was purchased and delivered.[188] SWEPCO believed not only that the air permit could be revised to reflect this engineering and design refinement, but also that this revision would be relatively quick and of little risk to the project schedule.[189] This belief was based on ADEQ's procedures for permit modifications. Generally, a technical change to the air permit that reduces environmental

---

[183] Tr. at 2100-2102.

[184] SWEPCO's clarification of Turk Auxiliary Boiler Information, SWEPCO Ex. 103 and Confidential SWEPCO Ex. 103A at Attachment 1; Tr. at 2035. The cost of the larger auxiliary boiler is public information.

[185] Confidential Tr. at 2102; *see* Confidential Rebuttal Testimony of Paul W. Franklin, SWEPCO Ex. 71A at 43.

[186] Tr. at 2070.

[187] Direct Testimony of Christian T. Beam, SWEPCO Ex. 28 at 83.

[188] Rebuttal Testimony of Venita McCellon-Allen, SWEPCO Ex. 65 at 16.

[189] Direct Testimony of Christian T. Beam, SWEPCO Ex. 28 at 83.

impacts can be accomplished at the ADEQ as an administrative or ministerial, uncontested matter. These types of minor changes are frequently done as final engineering is completed.[190]

SWEPCO then approached the ADEQ on the process for modifying the final air permit to include the modified auxiliary boiler. Two factors are critical in understanding this step of the process. The first factor is the timing of SWEPCO's approach to the ADEQ, which occurred after the air permit had been issued. The second is what the ADEQ told SWEPCO in response.

The timing of SWEPCO's approach to the ADEQ was driven by the necessity to have certain information in hand that was not easy to compile. The air permit was received in 2008. As Mr. Hendricks explained, changing the air permit requires far more substance than just a concept. The applicant must know exactly what it is changing, including design information, heat input, and emissions. These factors relate to the number of hours the auxiliary boiler will be needed during startup and commissioning during the first year of operation. All that engineering took several years to complete. Consequently, SWEPCO approached the ADEQ with the auxiliary boiler matter in 2010, once the information had been compiled.[191]

Despite the fact that the change in the boiler would reduce emissions, the ADEQ determined that a minor permit modification, not an administrative modification, would be required, one that would be subject to appeal. This course would entail a more extensive review and full public comment period, together with the prospect of another appeal. [192]

SWEPCO thus had two options: (1) revert to the originally permitted design (with the larger auxiliary boiler), or (2) maintain the new design and potentially delay Turk by months or years (with delay costs being approximately $10 million per month).[193] Given these options, SWEPCO prudently decided that it would not pursue an air permit amendment for the auxiliary boiler change. As Ms. McCellon-Allen put it:

> The risk to the Turk plant cost and schedule in essentially starting over on the air permit was a risk the Company did not believe was the best decision for the timely completion of the Turk plant at the lowest reasonable cost to our customers.

---

[190] Rebuttal Testimony of Venita McCellon-Allen, SWEPCO Ex. 65 at 16.

[191] Tr. at 189-191; Tr. at 2076-2077.

[192] Direct Testimony of Christian T. Beam, SWEPCO Ex. 28 at 83; Direct Testimony of John C. Hendricks, SWEPCO Ex. 29 at 14; Rebuttal Testimony of Venita McCellon-Allen, SWEPCO Ex. 65 at 16-17.

[193] Direct Testimony of Christian T. Beam, SWEPCO Ex. 28 at 83.

> The cost to procure the larger, permitted boiler and the engineering to install that boiler was $15 million dollars. ... [T]he delay cost resulting from a new hearing, which would have been required to use the smaller boiler, would have likely exceeded the installation cost of the larger boiler.[194]

This decision meant that the larger/original auxiliary boiler would be used.[195] This larger boiler is now the one installed and in service at Turk. The smaller boiler will be sold.

SWEPCO does not contend that having two auxiliary boilers is a desirable outcome. But SWEPCO does contend that, if one examines its actions step-by-step based on what it knew at the time, it acted prudently and in the best interest of customers in an attempt to improve Turk and reduce costs. This is why SWEPCO should be allowed to recover the costs of both auxiliary boilers.

If, however, the Commission disagrees with SWEPCO's rate request on this subject, then the course to take is clear. As Mr. Franklin explained, if the Commission decides to disallow the costs of the smaller auxiliary boiler because it is not used and useful, then the amount of the disallowance should be the cost of that specific item, not the cost of the larger boiler which is now in service.[196] In addition, if the costs of the smaller auxiliary boiler are disallowed, then SWEPCO should be allowed to retain all of the proceeds from its sale. In contrast, if the smaller auxiliary boiler is included in rate base, then any sale proceeds will be credited back to customers' benefit.[197]

7. Application of cost cap [PO Issues 6, 17]

As discussed *supra* at Section II.A.1.b., the cost cap imposed in PUCT Docket No. 33891 is not implicated in this case.

8. Welsh Unit Two

As discussed *supra* at Sections II.A.1.b. and II.A.3., the retirement of Welsh Unit 2 no later than 2016 is prudent given the Welsh Plant's uncontrolled status for SO_2 and is not an attendant impact of the Turk Plant. Consequently, it is inappropriate to consider the cost impact of the unit's retirement before it actually happens, other than to take the retirement in 2016 into

---

[194] Rebuttal Testimony of Venita McCellon-Allen, SWEPCO Ex. 65 at 17.

[195] Rebuttal Testimony of Venita McCellon-Allen, SWEPCO Ex. 65 at 17.

[196] Rebuttal Testimony of Paul W. Franklin, SWEPCO Ex. 71 at 44.

[197] Rebuttal Testimony of Venita McCellon-Allen, SWEPCO Ex. 65 at 17.

account in the depreciation calculation as discussed *infra* at Section IV.I.1.i.d, which Ms. McCellon-Allen stated only adds approximately $1.2 million to depreciation expense.[198]

B. Prepaid Pension Asset and ADIT Impacts [PO Issue 6]

1. Legal Authority Applicable to the Prepaid Pension Asset

In the 2005 Regular Legislative Session, the Legislature enacted Senate Bill 1447, which is codified in PURA § 36.065. In the first sentence of PURA § 36.065(a), the Legislature directed that:

> The regulatory authority shall include in rates of an electric utility expenses for pension and other post-employment benefits as determined by actuarial or other similar studies in accordance with generally accepted accounting principles, in an amount the regulatory authority finds reasonable.

In PUCT Docket No. 33309, the first contested electric utility rate case following the enactment of PURA § 36.065, the applicability of the statute to the inclusion in rate-base of the prepaid pension asset was litigated extensively.[199] In that docket, the Commission ruled: (i) that accounting for pensions under generally accepted accounting principles (GAAP) pursuant to Statement of Financial Accounting Standards No. 87 (FAS 87) requires that **both** the balance sheet and income statement effects must be taken into account; (ii) that the portion of the prepaid pension asset associated with pension expense included in operations and maintenance (O&M) expense should be included in rate base; (iii) that the accumulated deferred income taxes associated with the prepaid pension asset included in rate base should be included as a reduction to rate-base; and (iv) the portion of the prepaid pension asset associated with pension expense included in CWIP should not be included in rate base.[200]

The Commission adopted the ALJs' recommendations, including a recommendation that the portion of the prepaid pension asset associated with CWIP should not accrue a non-cash return through AFUDC.[201] On remand from the appeal of the final order in PUCT Docket

---

[198] *Id.* at 26.

[199] *Application of AEP Texas Central Company for Authority to Change Rates*, Docket No. 33309, Order on Rehearing (Mar. 3, 2008).

[200] Docket No. 33309, Order on Rehearing at FoF Nos. 25-32; CoL Nos. 11, 14-16.

[201] Docket No. 33309, Proposal for Decision at 8-18 (Aug. 30, 2006).

No. 33309, the Commission adopted a conclusion of law in PUCT Docket No. 38772 authorizing the accrual of AFUDC on the portion of the prepaid pension asset associated with CWIP.[202]

In PUCT Docket No. 39896, the recent Entergy Texas, Inc. (ETI) rate case, the Commission reaffirmed that the principles established in Docket Nos. 33309 and 38772 govern the ratemaking treatment of an electric utility's prepaid pension asset.[203]

2. SWEPCO's Requested Treatment of the Prepaid Pension Asset

In its application, SWEPCO requested that its prepaid pension asset as of December 31, 2011, of $113.2 million be treated in accordance with the Commission's decisions in PUCT Docket No. 33309.[204] SWEPCO requested that the "expense portion" of the prepaid pension asset (*i.e.*, the portion associated with O&M expense) of $80.7 million be included in rate base with the remaining $32.5 million associated with construction be included in CWIP.[205] SWEPCO included 35%, or $28.2 million of the $80.7 million of prepaid pension asset requested to be included in rate base, in ADFIT as a deduction to rate base.[206]

3. Other Parties' Positions

Intervenor witnesses Mark Garrett on behalf of CARD and Constance T. Cannady on behalf of Cities recommended that the Commission deny SWEPCO's request to include $80.7 million of the prepaid pension asset in rate base.[207] Both witnesses argued that the prepaid pension asset needed to be established under PURA § 36.065(b) and (c) and claimed that the prepaid pension asset was not supported by investor-supplied funds. Ms. Cannady also argued that several additional issues, including the funded position of the pension plan and certain changes in federal law on pension funding, constituted factors that should be taken into account in determining whether rate base treatment of SWEPCO's prepaid pension asset should be

---

[202] *Remand of Docket No. 33309 (Application of AEP Texas Central Company to Change Rates)*, Docket No. 38772, Order on Remand at CoL No. 15A (Jan. 20, 2011).

[203] *Application of Entergy Texas, Inc. for Authority to Change Rates, Reconcile Fuel Costs, and Obtain Deferred Accounting Treatment*, Docket No. 39896, Order on Rehearing at FoF Nos. 24-29 (Nov. 2, 2012).

[204] Direct Testimony of Hugh E. McCoy, SWEPCO Ex. 40 at 9-10, 28; Direct Testimony of Randall W. Hamlett, SWEPCO Ex. 34 at 45-46.

[205] Direct Testimony of Hugh E. McCoy, SWEPCO Ex. 40 at 28.

[206] Volume 12 of the Rate Filing Package, SWEPCO Ex. 10B at WP/G-7.4b under "Account 283 Accrued Book Pension Costs."

[207] Redacted Direct Testimony of Mark Garrett, CARD Ex. 5 at 9-14; Redacted Direct Testimony of Candace Cannady, Cities Ex. 2 at 15-26.

allowed.[208] Mr. Garrett also argued that if the prepaid pension asset were included in rate base, it should only earn a return equal to the interest rate used to calculate the pension cost reduction produced by the prepaid pension asset.[209]

4. SWEPCO's Response to Other Parties' Positions

In his rebuttal testimony, SWEPCO witness Hugh E. McCoy explained why the positions of Mr. Garrett and Ms. Cannady challenging rate base treatment for the prepaid pension asset lacked merit and should be rejected. In response to their arguments that rate base treatment for pension components may *only* be achieved through the establishment of a deferral mechanism under PURA § 36.065(b) and (c), Mr. McCoy explained that in PUCT Docket No. 33309 the Commission ruled that under GAAP as applied pursuant to PURA § 36.065(a), the prepaid pension asset is an appropriate asset for inclusion in rate base.[210] Mr. McCoy stated that the deferral mechanism under PURA § 36.065(b) and (c) is not intended to supplant the application of GAAP under FAS 87 as required under PURA § 36.065(a), but is optional and is intended to be available to address potential material fluctuations in pension expense.[211] Since SWEPCO did not expect its pension expense to fluctuate sufficiently to justify seeking a deferral mechanism under PURA § 36.065(b) and (c), it has not requested such a mechanism.[212]

With respect to Mr. Garrett's and Ms. Cannady's claims that the prepaid pension asset does not represent investor supplied funds, Mr. McCoy sponsored Exhibit HEM-1R showing the accumulation of the prepaid pension asset since the inception in 1987 of pension accounting under FAS 87.[213] Exhibit HEM-1R demonstrates that SWEPCO has made cash pension contributions of $152.0 million and that the cumulative net FAS 87 pension cost over this period has been $38.8 million, producing the net cumulative prepaid pension balance of $113.2 million as of December 31, 2011, which SWEPCO requests be accorded treatment in accordance with the Commission's decisions in PUCT Docket Nos. 33309 and 39896.[214]

---

[208] Redacted Direct Testimony of Candace Cannady, Cities Ex. 2 at 27-40.

[209] Redacted Direct Testimony of Mark Garrett, CARD Ex. 5 at 14.

[210] Rebuttal Testimony of Hugh E. McCoy, SWEPCO Ex. 79 at 5-7, 12-13, 25-26.

[211] Rebuttal Testimony of Hugh E. McCoy, SWEPCO Ex. 79 at 5-7, 12-13, 25.

[212] Rebuttal Testimony of Hugh E. McCoy, SWEPCO Ex. 79, at 6, 25.

[213] Rebuttal Testimony of Hugh E. McCoy, SWEPCO Ex. 79 at Exhibit HEM-1R.

[214] Rebuttal Testimony of Hugh E. McCoy, SWEPCO Ex. 79 at 7-9.

Mr. McCoy further responded to Mr. Garrett's and Ms. Cannady's contentions that his calculation of the prepaid pension asset under FAS 87 fails to take into account the amount of pension cost included in prior rates by explaining that their position is inconsistent with rate making principles in general, application of GAAP accounting pursuant to FAS 87, and the Commission's findings in Docket Nos. 33309 and 39896.[215]

Mr. McCoy also responded to Ms. Cannady's additional arguments about the mechanics of his calculation, the funded position of SWEPCO's pension plan, recent federal legislation addressing pension funding requirements, and SWEPCO's intentions regarding plan funding by pointing out that Ms. Cannady's criticisms did not reflect a proper understanding of the applicable GAAP pension expense accounting under FAS 87 and confused the pension expense accounting under FAS 87 with ERISA funding, which operates under different rules.[216]

Finally, both SWEPCO witnesses Randall W. Hamlett and Hugh E. McCoy in their rebuttal testimonies responded to Mr. Garrett's argument that if the prepaid pension asset is included in rate base, it should only earn a return equal to the interest rate used to calculate the pension cost reduction provided by the prepaid pension asset.[217] They pointed out that Mr. Garrett's proposal to establish a specific unique return that a particular asset earns based on a benefit analysis was inconsistent with the concept of establishing an overall just and reasonable return for a utility. If one of a utility's assets in rate base receives a reduced return, the return for other assets would need to be increased, or the utility would not have a reasonable opportunity to earn its authorized return.[218]

Mr. Hamlett also addressed Mr. Garrett's assertion that, because a 7.5% interest rate is used to produce the pension savings from the prepaid pension asset included as a reduction to cost of service, SWEPCO seeks to have its customers pay more in return on the prepaid pension asset than the benefit they receive.[219] In making this assertion, Mr. Hamlett stated, Mr. Garrett failed to recognize that the calculation of the pension cost reduction to cost of service applies the

---

[215] Rebuttal Testimony of Hugh E. McCoy, SWEPCO Ex. 79 at 9-11, 13, 19.

[216] Rebuttal Testimony of Hugh E. McCoy, SWEPCO Ex. 79 at 14-27.

[217] Rebuttal Testimony of Randall W. Hamlett, SWEPCO Ex. 73 at 23-29; Rebuttal Testimony of Hugh E. McCoy, SWEPCO Ex. 79 at 11-12.

[218] Rebuttal Testimony of Randall W. Hamlett, SWEPCO Ex. 73 at 23-24, 28-29; Rebuttal Testimony of Hugh E. McCoy, SWEPCO Ex. 79 at 11-12.

[219] Rebuttal Testimony of Randall W. Hamlett, SWEPCO Ex. 73 at 24-28.

7.5% interest rate to the entire $113.2 million amount of prepaid pension asset, while the portion of the prepaid pension asset upon which SWEPCO seeks the opportunity to earn a return, whether through inclusion in rate base or through AFUDC on the CWIP portion, is only 65% of the $113.2 million amount of the prepaid asset pension as a result of the ADFIT offset.[220] When the ADFIT offset is taken into account, the pension cost saving benefits customers receive from the $113.2 million of prepaid pension asset which SWEPCO requests be recognized for ratemaking purposes are greater than the return sought by SWEPCO at its requested overall cost of capital, which includes the 11.25% return on equity.[221]

5. Summary

The governing legal principles and facts in evidence establish that SWEPCO has fully supported its request to include the $80.7 million portion of its prepaid pension asset associated with O&M pension expense in rate base and earn an AFUDC return on the $28.5 million portion associated with construction. None of the arguments made by CARD or Cities have any merit or raise any credible reason to deviate from the Commission's prior rulings in Docket Nos. 33309 and 39896 on the ratemaking treatment of the prepaid pension asset. CARD's and Cities' arguments that SWEPCO should not be accorded the treatment provided to the utilities in Docket Nos. 33309 and 39896 lack merit and should be rejected.

C. Oxbow Investment [PO Issue 6]

In December 2009, Central Louisiana Electric Company (CLECO) and SWEPCO formed the Oxbow Lignite Company, which acquired the Oxbow Mine Reserves from Red River Mining Company (RRMC) for approximately $25.7 million.[222] As part of that transaction, the Dolet Hills Lignite Company (DHLC), a wholly owned subsidiary of SWEPCO, acquired the RRMC's mining assets for an additional $15.8 million.[223] SWEPCO is requesting that its share of the investment in the Oxbow lignite reserves – $14,532,294 as of the end of the test year – be included in rate base.

---

[220] Rebuttal Testimony of Randall W. Hamlett, SWEPCO Ex. 73 at 25-28.

[221] Rebuttal Testimony of Randall W. Hamlett, SWEPCO Ex. 73 at 25-28. Mr. Hamlett concluded by reiterating that even if the return component SWEPCO sought were to exceed the pension cost reduction, any "attempt to affect the return for...specific individual assets based on some so-called benefit received by customers...violates the ratemaking process employed by the Commission and should be rejected." *Id.* at 28-29.

[222] Direct Testimony of Gregory A. Wright, SWEPCO Ex. 48 at 9-10.

[223] Rebuttal Testimony of Gregory A. Wright, SWEPCO Ex. 85 at 10.

Staff witness Joe Luna recommends a 50% reduction to SWEPCO's request for Oxbow lignite investment costs in rate base.[224] His recommendation is based on the fact that SWEPCO did not provide an appraisal of the lignite reserves.[225] He mistakenly claims that the reasonableness of the price paid by SWEPCO for the Oxbow lignite reserves cannot be determined absent an appraisal.[226] Mr. Luna provides no explanation as to how he conjured up the 50% reduction figure.

SWEPCO witness Gregory Wright explained that the lignite reserves were not appraised because the lignite has no fair market value, which he defined as the "price at which an asset would exchange between a willing buyer and a willing seller, each having reasonable knowledge of all pertinent facts without either being under any compulsion to buy or sell."[227] Mr. Wright testified that the only viable market for lignite in the Oxbow mine is the Dolet Hills Power Station (DHPS).[228] And he confirmed that due to the high cost of transporting lignite, there are no other commercial operations in Louisiana or Texas that would be willing to acquire the reserve and try to sell it on the open market.[229] Consequently, an appraisal would have been meaningless.[230] Nevertheless, Mr. Wright noted that the price paid for the Oxbow reserves falls within the range of prices that SWEPCO has paid for lignite at the Sabine Mine.[231] Mr. Wright opined, based on his years of mining experience, that the price paid for the Oxbow reserves was reasonable and the least cost alternative for extending the life of the Dolet Hills plant.[232]

The Oxbow lignite acquisition was necessary to extend the life of the DHPS from 2016-2019 to at least 2026.[233] Prior to the selection of the Oxbow reserves, SWEPCO, CLECO, and DHLC analyzed multiple fueling alternatives and determined the Oxbow acquisition was the

---

[224] Redacted Direct Testimony of Joe Luna, Staff Ex. 3 at 39-40.

[225] Redacted Direct Testimony of Joe Luna, Staff Ex. 3 at 39-40.

[226] Redacted Direct Testimony of Joe Luna, Staff Ex. 3 at 39-40.

[227] Rebuttal Testimony of Gregory A. Wright, SWEPCO Ex. 85 at 11.

[228] Rebuttal Testimony of Gregory A. Wright, SWEPCO Ex. 85 at 11.

[229] Rebuttal Testimony of Gregory A. Wright, SWEPCO Ex. 85 at 11.

[230] Rebuttal Testimony of Gregory A. Wright, SWEPCO Ex. 85 at 11.

[231] Rebuttal Testimony of Gregory A. Wright, SWEPCO Ex. 85 at 11.

[232] Rebuttal Testimony of Gregory A. Wright, SWEPCO Ex. 85 at 11.

[233] SWEPCO's Response to TIEC's RFI 2-7, SWEPCO Ex. 104.

least cost option for securing a reliable fuel supply sufficient to meet the needs of the DHPS for the remainder of its economic life.[234]

In response to Commission Staff's Thirty-Third Request for Information, Question No. 33-1(e), SWEPCO provided the underlying information regarding the various fuel alternatives that were identified and analyzed.[235] In addition, in his rebuttal testimony, Mr. Wright described the advantages and disadvantages and provided the economic analysis of each fueling alternative.[236] Mr. Wright acknowledged that this same analysis was submitted to the LPSC in Docket No. U-30975 in support of SWEPCO's request to amend the fuel cost recovery mechanism in that jurisdiction.[237] The LPSC's Order in Docket No. U-30975 states that the LPSC Staff "reviewed the information and data supplied by the Companies and has determined that the purchase of the Oxbow mine is prudent, reasonable, continues desired fuel diversity and results in the most economic fuel cost alternative for the DHPS and the lowest reasonable cost for Louisiana ratepayers."[238] Cities witness Lane Kollen, whose firm assisted the LPSC Staff in Docket U-30975, verified that he personally reviewed the data supplied by the companies in that proceeding and that he concluded that the Oxbow acquisition was reasonable and necessary.[239]

Mr. Luna's recommended disallowance lacks merit and should be discarded.

D. Mountaineer Carbon Capture & Storage Project [PO Issue 15]

The most laudable intentions can draw the heaviest fire. So it is with SWEPCO's request to recover costs of the engineering and design study associated with the Mountaineer Carbon Capture and Storage (CCS) project. As its name suggests, the CCS project addressed one of the most widely discussed issues of our times—global warming and climate change. The CCS project studies a method of separating carbon dioxide (CO_2) from the flue gas generated from a coal fired power plant and storing the CO_2 underground. It was undertaken by AEP at the Mountaineer Plant, which is owned by SWEPCO affiliate Appalachian Power Company. As

---

234 Rebuttal Testimony of Gregory A. Wright, SWEPCO Ex. 85 at 12.

235 Rebuttal Testimony of Gregory A. Wright, SWEPCO Ex. 85 at 12; Optional Completeness to Staff Ex. 14, SWEPCO Exhibit No. 106, at Attachment (e).

236 Rebuttal Testimony of Gregory A. Wright, SWEPCO Ex. 85 at 12-16.

237 Rebuttal Testimony of Gregory A. Wright, SWEPCO Ex. 85 at 16.

238 SWEPCO's Response to TIEC's RFI 2-7, SWEPCO Exhibit 104, Attachment at 4.

239 Tr. at 1554.

Mr. Franklin explained, it was undertaken so that AEP could determine the applicability and viability of the technology in addressing CO_2 emissions and potential regulatory restrictions.[240]

It is important to grasp the scope of the costs that SWEPCO seeks to recover. There was first a CCS physical project at the Mountaineer Plant that was constructed and operated on a 20 MW scale.[241] After that project was successfully completed, a front end engineering and design (FEED) study was undertaken to determine what it would take to scale up the design to 235 MW. This study received partial funding from the Department of Energy and another entity. After this FEED study was completed, however, it was determined that the current market would not support the investment for a commercial scale facility. Thus, the project was put on hold, where it remains.[242]

SWEPCO does not seek to recover any facility or hard physical asset costs, nor any costs of the 20 MW project that was built and operated. Instead, SWEPCO's request is limited to its share of the subsequent CCS FEED study for the 235 MW commercial scale facility.[243] SWEPCO's rate request is to recover its allocated share of the FEED study costs, which correlates to the percentage of its generating units to which CCS could potentially be retrofitted versus AEP's total generation that could be retrofitted (or a 16.3% allocation).[244] SWEPCO seeks (1) to include $2,379,609 in rate base as a regulatory asset,[245] and (2) to recover this asset through a five-year amortization period, which results in $475,922 included in cost of service.[246]

Cities' Mr. Kollen[247] and Staff's Mr. Luna[248] question the threshold eligibility of these costs as a regulatory asset.[249] Mr. Kollen urges that the Commission did not grant SWEPCO the

---

[240] Direct Testimony of Paul W. Franklin, SWEPCO Ex. 32 at 58-59.

[241] Rebuttal Testimony of Paul W. Franklin, SWEPCO Ex. 71 at 41.

[242] Rebuttal Testimony of Paul W. Franklin, SWEPCO Ex. 71 at 42.

[243] Rebuttal Testimony of Paul W. Franklin, SWEPCO Ex. 71 at 42; Tr. at 2098.

[244] Rebuttal Testimony of Paul W. Franklin, SWEPCO Ex. 71 at 39; Redacted Direct Testimony of Joe Luna, Staff Ex. 3 at 19.

[245] Redacted Direct Testimony of Joe Luna, Staff Ex. 3 at 19-20.

[246] Direct Testimony of Randall W. Hamlett, SWEPCO Ex. 34 at 30.

[247] Direct Testimony of Lane Kollen, Cities Ex. 3 at 24-26.

[248] Redacted Direct Testimony of Joe Luna, Staff Ex. 3 at 19-20.

[249] The amount of the regulatory asset in rate base is $2,379,609. Redacted Direct Testimony of Joe Luna, Staff Ex. 3 at 20.

authority to defer these costs in Account 182 as a regulatory asset.[250] Similarly, Mr. Luna urges that the Commission did not approve the creation of a regulatory asset.[251]

Mr. Hamlett explained why these costs are eligible for rate base treatment. Deferral of costs or the creation of a regulatory asset under GAAP is a management decision requiring no commission order. In contrast, rate recovery does require commission approval, and this is what SWEPCO seeks in this case. If the request is denied, then the regulatory asset will be written off or expensed.[252]

As for the merits of rate recovery, SWEPCO's request is based on a modest, forward-looking project and should be granted. As Mr. Franklin explained, the CCS project was a laudable, cutting edge effort to find a feasible solution for one of the most discussed environmental issues of our times. CCS projects have not been undertaken on a utility commercial scale, so they cannot be ordered off the shelf in a fashion similar to other commercially available environmental control technologies. For this reason, the knowledge gained by SWEPCO and AEP by performing this project has value for SWEPCO's customers.[253] It will better position SWEPCO, together with the AEP system, to comply with future regulations on CO_2 emissions. The costs for SWEPCO are modest--$475,922 in cost of service. SWEPCO will be one step ahead if carbon restrictions are enacted, and the CCS project is inexpensive insurance for that event.

Commission precedent supports SWEPCO's request and shows a policy to encourage modest research efforts on important issues. In PUCT Docket No. 7510,[254] West Texas Utilities Company (WTU), which sought to include the coal-fired Oklaunion plant in rates, successfully sought recovery of a contribution for research related to acid rain:

> WTU contributed $17,500 to acid rain research through the Living Lakes research program. Although the Cities disputed the inclusion of that amount in cost of service, WTU now owns a coal-fired plant (Oklaunion) and anticipated that future plants will be coal or lignite-fired. **The burning of coal and lignite may result in acid rain, and the research to which the Company has contributed is**

---

[250] Direct Testimony of Lane Kollen, Cities Ex. 3 at 24-25.

[251] Redacted Direct Testimony of Joe Luna, Staff Ex. 3 at 20.

[252] Rebuttal Testimony of Randall W. Hamlett, SWEPCO Ex. 73 at 29.

[253] Rebuttal Testimony of Paul W. Franklin, SWEPCO Ex. 71 at 38.

[254] *Application of West Texas Utilities Company for Authority to Change Rates*, Docket No. 7510, 14 P.U.C. BULL. 620 (Nov. 30, 1987).

> **directed to studying the potential connection.** The examiners believe WTU's participation in the research is reasonable and recommend inclusion of the full amount.[255]

Finding of Fact 107 affirmed that, "Expenses for the Living Lakes research program are potentially connected to ownership of Oklaunion and are reasonable."[256]

Substitute "may contribute to climate change" for "may result in acid rain" in the highlighted passage above, and the relevance of the WTU precedent becomes even more pronounced.

In PUCT Docket No. 14965,[257] a Central Power and Light Company (CPL) rate case, the Commission allowed recovery of the Laredo project costs. This research project with some demand side management applicability allowed customers to interrupt their loads at critical times to help CPL avoid additional generation and transmission costs. The benefits were reduced customer bills and avoiding generation and transmission constraints.[258] The Commission allowed recovery of $1,433,109 in invested capital, to be amortized over ten years.[259]

While the CPL PUCT Docket No. 14965 case is not as close on point as the WTU case, the CPL case also supports the notion that modest research efforts on important issues should be encouraged.

In conclusion, the Mountaineer CCS project is eligible for rate base treatment. Projects that are timely, important and modest should be encouraged. The CCS project costs fit that bill.

E. Capitalized Incentive Compensation

The Company's reasoning supporting recovery of capitalized incentive compensation is the same as for incentive compensation expense, and is explained in Section IV.K.2.

---

[255] 14 P.U.C. BULL. at 758 (emphasis added).

[256] 14 P.U.C. BULL. at 834. The Examiners' Report was adopted on this point at 14 P.U.C BULL. at 893.

[257] *Application of Central Power and Light Company for Authority to Change Rates*, Docket No. 14965, Second Order on Rehearing, (Oct. 16, 1997).

[258] Docket No. 14965, Second Order on Rehearing at 49, FoF No. 125.

[259] Docket No. 14965, Second Order on Rehearing at 92, CoL No. 46.

III. Rate of Return [PO Issues 4, 5]

A. Return on Equity [PO Issue 5]

1. Introduction

The return on equity (ROE) represents the profit component of a utility's rates. According to the Commission's substantive rules, the ROE shall reflect the cost of common stock, or equity, and "shall be based on a fair return on its market value."[260] Company witness Robert B. Hevert sponsored SWEPCO's proposed ROE consistent with this standard. In recognition of the stabilization of certain measures of market conditions since the filing of his direct testimony. Mr. Hevert updated his analysis in his rebuttal testimony and reduced the lower end of his reasonable range of ROE estimates from 10.75% to 10.5%.[261] With that reduction, Mr. Hevert's reasonable range of ROE estimates becomes 10.5% to 11.5%, and his recommended ROE is 11.25%.[262]

The witnesses for the other parties have raised a number of criticisms regarding Mr. Hevert's models, methodologies and results. In large part, these amount to claims that the growth rates and risk premiums that Mr. Hevert employs are too high or not sustainable, that historically low interest rates equate to a historically low cost of capital, and that current market conditions are stable and low risk from the standpoint of utility stocks.

As shown throughout the Mr. Hevert's direct and rebuttal testimony and this brief, the other witnesses paint an inaccurate and incomplete picture of the capital markets and ignore the sound bases for the inputs to and results of Mr. Hevert's models. His growth rates for the Discounted Cash Flow Model appropriately reflect the very long term growth rates that the model requires and which the other witnesses fail to capture. His equity risk premium estimates, which represent the additional return that investors demand for the additional risk associated with equity investments, reflect current market conditions, where rising spreads between the return on lower and higher risk investments indicate that risk premiums are higher than assumed by the other witnesses. Factors such as these, plus the recent poor performance of the utility sector in the stock market, point to a cost of equity in the range proposed by Mr. Hevert, not that

---

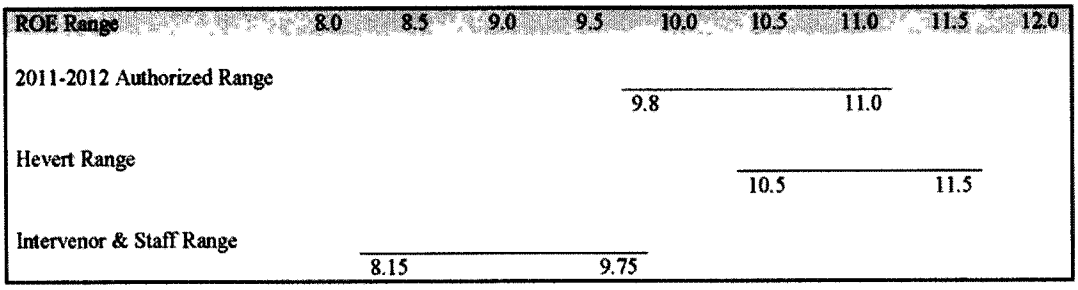
[260] P.U.C. SUBST. R. § 25.231(c)(1)(C)(ii).

[261] Direct Testimony of Robert B. Hevert, SWEPCO Ex. 35 at 4; Rebuttal Testimony of Robert B. Hevert, SWEPCO Ex. 74 at 5-6.

[262] Rebuttal Testimony of Robert B. Hevert, SWEPCO Ex. 74 at 5-6.

of the other witnesses. Furthermore, SWEPCO-specific risk factors, discussed below, support Mr. Hevert's 11.25% ROE recommendation.

Finally, because Mr. Hevert's ROE recommendation diverges from those of the other witnesses, some of the other parties have tried to characterize his position as an outlier.[263] When considered in light of ROEs recently authorized around the country by regulators, however, it is the Staff and Intervenors whose recommendations are outliers. The range of ROE results considered reasonable by the various witnesses is shown below, compared to the range of authorized returns awarded by regulators in 2011-2012:



The central tendency for authorized returns awarded by regulators has remained very stable, between 10% and 10.5%, for the years 2011-2012, the same period during which falling interest rates have led intervenor witnesses to predict falling cost of equity. This should not come as a surprise, however, because it is **risk aversion** (and the artificial suppression of interest rates through federal monetary policy) that has driven interest rates down.[264] The chart above shows that the reasonable ROE range of only one witness—Mr. Hevert—overlaps the range of ROEs awarded by regulators. Most recently, for the whole of 2012, as well as the last quarter of 2012, the median return authorized for vertically integrated electric companies like SWEPCO was 10.2%.[265] The median authorized return in that time period for jurisdictions considered "credit supportive" by S&P was 10.3%.[266] These levels are 65-75 basis points above the highest ROE recommended by any Staff or intervenor witness.

Both the reasonable range and the ROE recommendations of the other witnesses fall well below the ROEs authorized to utilities around the nation who are similarly situated to

---

[263] *E.g.*, Tr. at 1971-1974.

[264] Rebuttal Testimony of Robert B. Hevert, SWEPCO Ex. 74 at 8.

[265] Rebuttal Testimony of Robert B. Hevert, SWEPCO Ex. 74 at 137, Exhibit RBH-27R.

[266] Rebuttal Testimony of Robert B. Hevert, SWEPCO Ex. 74 at 139.

SWEPCO.[267] Yet it is undisputed that SWEPCO is entitled under the Texas and United States Constitutions to the opportunity to earn a return that is competitive with those of its peers.[268] As Mr. Hevert notes, "[t]aken in that context, the salient issue is not why my ROE range is removed from theirs. Rather, the question becomes why their ranges are so far removed from what recently has been observed in the market."[269]

a. Economic Conditions

Various intervenor witnesses take the position that the current historically low interest rates, in combination with what they term benign market conditions and the position of utility stocks as a "safe haven" for investors, translate directly into a historically low cost of equity.[270] So low, in fact, that these intervenors develop ROE ranges and recommendations lower than anything actually being granted now, or ever before, by regulatory agencies.[271] As Mr. Hevert explains, the fact is that recent authorized returns have not gone down with the drop in interest rates; clearly regulatory authorities are seeing more to the picture, and are considering other facts and circumstances indicating a higher cost of equity for utilities.[272] Mr. Hevert points to several important indicators pointing to higher risk and higher cost of equity for utilities.

The first indicator is the trend in "credit spreads," which is the increased return that debt investors require to invest in a security, depending on its riskiness compared to a comparable treasury security.[273] Although treasury interest rates have gone down in the 2010-2012 period, in the same period credit spreads for utility debt have increased, showing that the risk premium is increasing for taking on more credit risk.[274] At the same time, steadily decreasing interest rates mean steadily increasing risk premiums for equity investment in utility stocks, due to the well-established inverse relation between the two.[275] Mr. Cutter agreed that under current market

---

[267] Rebuttal Testimony of Robert B. Hevert, SWEPCO Ex. 74 at 6.

[268] Direct Testimony of Robert B. Hevert, SWEPCO Ex. at 35 at 8-9 (quoting *Hope* and *Bluefield* decisions).

[269] Rebuttal Testimony of Robert B. Hevert, SWEPCO Ex. 74 at 9.

[270] *E.g.,* Direct Testimony of Carol Szerszen, OPUC Ex. 2 at 10-11; Direct Testimony of Stephen G. Hill, Cities ex. 1 at 14-15.

[271] Rebuttal Testimony of Robert B. Hevert, SWEPCO Ex. 74 at 5-6.

[272] Rebuttal Testimony of Robert B. Hevert, SWEPCO Ex. 74 at 7-8, 76.

[273] Direct Testimony of Robert B. Hevert, SWEPCO Ex. 35 at 43.

[274] Direct Testimony of Robert B. Hevert, SWEPCO Ex. 35 at 44-45; Rebuttal Testimony of Robert B. Hevert, SWEPCO Ex. 74 at 6, 55-56, Exhibit RBH-14R.

[275] *E.g.,* Rebuttal Testimony of Robert B. Hevert, SWEPCO Ex. 74 at 57.

conditions, where bond interest rates are falling faster than stock market returns, the equity risk premium should be expected to increase.[276]

The second indicator is the trend in "yield spreads," which is the difference between the yield on long term treasury securities and the dividend yield on utility stocks. Disruptions in the relation between these yields are an indicator of market dislocation.[277] Historically, from 2000-2008, the prevailing relationship was that the yield on 30-year treasury bonds exceeded the dividend on utility stocks. That relationship changed in 2008, with the financial crisis, and the associated market dislocation created a situation where utility stock dividend yields exceeded the treasury bond yield, indicating higher equity investor return requirements. At present, if treasury bond yields and dividend yields had their conventional, pre-2008 relationship, and the very low current interest rates equated to very low utility cost of capital, one would expect an average dividend yield of 2.31% or lower. Instead, the dividend yield for Mr. Hevert's proxy group is about twice that (4.62%), another indicator of a higher cost of utility equity than intervenors' theories regarding interest rates would support.[278] Even as treasury bond yields continued to fall in 2012, utility dividend yields remained stable, and have begun to further increase.[279]

The third indicator of a higher utility cost of equity concerns utility stock "volatility" (how severely a security or market index varies from the average performance) and utility stock "correlation" (stocks with higher correlation to the broader stock market are riskier).[280] Though utility stock volatility has moderated, it remains somewhat higher than historical averages. At the same time, from 2000-2012, there has been a steady, long-term increase in the degree of correlation between utility stocks and the broader market, indicating an overall higher degree of risk for utility stock, compared to the broader market, than was the case in the past.[281]

Finally, it is not the case that utility stocks are currently a "safe haven" for investors. To the contrary, utility stocks significantly under-performed the market in 2012, producing negative

---

[276] Tr. at 1682.

[277] Direct Testimony of Robert B. Hevert, SWEPCO Ex. 35 at 46-47.

[278] Direct Testimony of Robert B. Hevert, SWEPCO Ex. 35 at 47-49.

[279] Rebuttal Testimony of Robert B. Hevert, SWEPCO Ex. 74 at 56.

[280] Direct Testimony of Robert B. Hevert, SWEPCO Ex. 35 at 49-50.

[281] Direct Testimony of Robert B. Hevert, SWEPCO Ex. 35 at 51-54.