



Control Number: 51415



Item Number: 619

Addendum StartPage: 0

**SOAH DOCKET NO. 473-21-0538  
DOCKET NO. 51415**

2021 JUN 17 PM 3:25

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

**COMMISSION STAFF'S INITIAL BRIEF**

Dated: June 17, 2021

Respectfully submitted,

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<b>AUTHORITY TO CHANGE RATES</b>	<b>§</b>	<b>ADMINISTRATIVE HEARINGS</b>

**COMMISSION STAFF'S INITIAL BRIEF**

**I. Introduction/Summary [Preliminary Order (PO) Issues 1, 2, and 3]**

Southwestern Electric Power Company (SWEPCO) proposes an overall revenue increase that exceeds that allowed by the Public Utility Regulatory Act (PURA), Commission Precedent, or public policy. Among them include, but are not limited to, the following: a 10.35% return on equity (ROE), much higher than Staff witness Mark Filarowicz's recommended ROE of 9.35%; the inclusion of accumulated deferred federal income tax (ADFIT) balance of \$455,122,940 in rate base, related to the sale of a net operating loss carryforward (NOLC) ADFIT asset to SWEPCO's parent company AEP, Inc.; and the undepreciated balance of the Dolet Hills plant that will be retired by December 31, 2021.

Instead, Staff recommends adoption of a 12.5 basis point reduction for ROE, based on interruptions in service and reliability concerns stemming from improper vegetation management (VM) practices, resulting in a recommended ROE for SWEPCO of 9.225%. Additionally, Staff proposes that SWEPCO be ordered to hire an independent contractor to promptly conduct a comprehensive review of SWEPCO's transmission system and make recommendations regarding SWEPCO's VM practices, facilities, replacement, and transmission system protection. To improve SWEPCO's poor reliability on its distribution system, Staff proposes that SWEPCO should be ordered to move to a four-year vegetation trim cycle within twelve months of the filing of the final order in this docket. Both Staff and SWEPCO's witness agree that a four-year trim cycle is the best long-term solution for VM.<sup>1</sup>

Staff's adjustments-before accounting for Intervenor's positions that the Commission may adopt-results in a Texas retail revenue requirement of approximately \$410 million.<sup>2</sup> Inclusive of

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<sup>1</sup> Direct Testimony of Drew Seidel, SWEPCO Ex. 10 at 20:3-6.

<sup>2</sup> Direct Testimony of Adrian Narvaez, Staff Ex. 4 at bates 33, Attachment AN-2.

existing Transmission Cost Recovery Factor (TCRF) and Distribution Cost Recovery Factor (DCRF) revenues, this represents an increase of approximately \$49 million over existing revenues and a significant reduction to SWEPCO's request to increase its revenues by approximately \$85 million.<sup>3</sup>

For collecting these proposed revenues, Staff's cost allocation, revenue distribution, and rate design proposals are reflective of cost causation principles and goals routinely underscored by the Commission. In contrast with SWEPCO's arbitrary rate design proposals, Staff witness Adrian Narvaez employed a phased-in revenue distribution methodology to gradually bring all rate classes to the Commission's goal of having rates for all classes set at cost.<sup>4</sup> Staff's cost of service model, revenue distribution, and rate design should be adopted in this proceeding and used for number-running proposals and for developing TCRF and DCRF baselines.

## **II. Invested Capital - Rate Base [PO Issues 4, 5, 10, 11, 12, 13, 14, 15, 16, 18, 19, 20, 21, 22]**

### **A. Generation, Transmission, and Distribution Capital Investment [PO Issues 4, 5, 10, 11, 13, 14, 15, 16]**

Staff urges the Administrative Law Judges (ALJs) to adopt Staff's proposal regarding the retirement of the Dolet Hills Power Plant as stated in the testimony of Staff witness Ruth Stark and outlined below in Section II.A.1. Furthermore, Staff urges the ALJs to adopt Staff's proposal regarding the retired gas-fired generating units as stated in Ms. Stark's testimony and outlined below in Section II.A.2.

#### **1. Dolet Hills Power Station [PO Issues 67, 68, 69, 70, 71]**

Staff urges the ALJs to adopt Staff's position regarding the retirement of Dolet Hills including (1) allowing SWEPCO to recover the return, depreciation, O&M, and taxes associated with the operation of Dolet Hills, (2) requiring SWEPCO to remove its requested net book value associated with Dolet Hills and the Oxbow mine investment from rate base as well as the associated Dolet Hills depreciation expense from cost of service after the retirement date; (3) requiring SWEPCO book a regulatory asset of \$118,936,606 to allow recovery of but not on the remaining

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<sup>3</sup> Staff Ex. 4 at bates 44, Attachment AN-6; Rebuttal Testimony of Michael Baird, SWEPCO Ex. 36 at Ex. MAB-1R.

<sup>4</sup> *Application of Southwestern Electric Power Company for Authority to Change Rates*, Docket No. 46449, Proposal for Decision at 295 (Sep. 22, 2017).

net book balance of SWEPCO's Dolet Hills investment; and (4) treating the early retirement of Dolet Hills in a manner similar to the way the Commission treated the early retirement of SWEPCO's Welsh Unit 2 in Docket No. 46449.

SWEPCO and Cleco Power, LLC, the joint owners of Dolet Hills, determined that all economically recoverable lignite had been recovered from the associated Dolet Hills mines and the decision was made that the Dolet Hills plant would be retired no later than December 31, 2021.<sup>5</sup> SWEPCO proposes to offset the undepreciated balance of Dolet Hills with the balance of excess ADFIT liabilities owed to ratepayers associated with the Tax Cuts and Jobs Act of 2017 (TCJA).<sup>6,7</sup> Because the proposed offset for the excess ADFIT liabilities owed ratepayers as calculated by SWEPCO is less than the undepreciated book balance of Dolet Hills, SWEPCO proposes to amortize the remaining balance after the offset over a four-year period, which is the time period SWEPCO anticipates between rate cases.<sup>8</sup>

SWEPCO quantified its total requested revenue requirement associated with Dolet Hills as \$29,434,851.<sup>9</sup> However, an additional \$1,847,918 of base rate fuel expenses,<sup>10</sup> and \$442,574 of property insurance expense<sup>11</sup> are included in its requested revenue requirement. Also included are costs related to the Dolet Hills mining operations that will cease production.<sup>12</sup> These include \$1,412,622 of return and associated federal income taxes on SWEPCO's Oxbow mine investment and the equity return of \$1,418,666 on its Dolet Hills Lignite Company investment.<sup>13</sup> The sum of these additional expenses plus SWEPCO's initial quantification equals \$34,556,631 of expenses in SWEPCO's requested annual revenue requirement for a plant and related mining operations that

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<sup>5</sup> Direct Testimony of Thomas Brice, SWEPCO Ex. 4 at 6:7-12.

<sup>6</sup> Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115-97, 113 Stat. 2054 (Dec. 22, 2017).

<sup>7</sup> Direct Testimony of Michael Baird, SWEPCO Ex. 6 at 23:7-10.

<sup>8</sup> *Id.* at 23:10-11.

<sup>9</sup> Direct Testimony of Ruth Stark, Staff Ex. 3 at Attachment RS-26.

<sup>10</sup> *Id.* at Attachment RS-27.

<sup>11</sup> *Id.* at Attachment RS-22.

<sup>12</sup> Staff Ex. 3 at 22:8-10.

<sup>13</sup> *Id.* at 22:10-14.

will cease to be used and useful just two months after the final order deadline in this proceeding.<sup>14</sup> Over the course of the anticipated four-year time-period between rate cases, Commission approval of SWEPCO's request would result in them recovering a total of \$138,226,524 (\$34,556,631 annually, over the course of four years) for a plant and mining operations that will not be providing service to ratepayers for at least 46 out of the next 48 months.<sup>15</sup>

Ms. Stark proposes that the Commission allow SWEPCO to recover the return, depreciation, Operating and Maintenance (O&M), and taxes associated with the operation of Dolet Hills from March 18, 2021 (the relate-back date of rates in this proceeding) through December 31, 2021.<sup>16</sup> Ms. Stark further proposes to remove SWEPCO's requested net book value associated with Dolet Hills and the Oxbow mine investment from rate base as well as the associated Dolet Hills depreciation expense from cost of service after that date.<sup>17</sup> Finally, Ms. Stark recommends that SWEPCO book a regulatory asset of \$118,936,606 to allow recovery of but not on the remaining net book balance of SWEPCO's Dolet Hills investment on December 31, 2021 over the projected remaining life for the plant from Docket No. 46449.<sup>18</sup> Based on that projection, on its December 31, 2021 retirement date, the amortization period for recovery of the Dolet Hills regulatory asset would be 24.5 years.<sup>19</sup> Ms. Stark calculated all of these amounts and divided the total by four years to reflect the time-period when rates from this case are presumed to be in effect.<sup>20</sup> Ms. Stark's proposed treatment of the retirement of Dolet Hills results in the inclusion of \$11,573,440 in SWEPCO's revenue requirement as follows:<sup>21</sup>

Return and FIT	\$ 1,865,403
Depreciation	\$ 1,625,489
Amortization	\$ 3,944,326

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<sup>14</sup> *Id.* at 22:14-18.

<sup>15</sup> *Id.* at 22:18-21.

<sup>16</sup> *Id.* at 25:4-6.

<sup>17</sup> *Id.* at 25:8-10.

<sup>18</sup> *Id.* at 25:10-14.

<sup>19</sup> *Id.* at Attachment RS-34

<sup>20</sup> *Id.* at Attachment RS-33 at 1.

<sup>21</sup> Staff Ex. 3 at 25:19 – 26:3.



O&M	\$ 3,174,560
Oxbow Return	\$ 254,737
Property Taxes	<u>\$ 708,925</u>
Total	\$11,573,440

SWEPCO claims that its proposal with respect to Dolet Hills is consistent with the Commission's treatment of Welsh Unit 2 in Docket No. 40443 because SWEPCO's proposed treatment of Dolet Hills includes the still-operating unit in rate base and includes all applicable expenses so that the unit can continue to operate at the beginning of the rate year.<sup>22</sup> SWEPCO also claims that the Commission's post-test-year adjustment rule, 16 TAC § 25.231(c)(2)(F)(iii), applies to plants retired prior to the rate year, so it would not be appropriate to remove costs associated with Dolet Hills from rate base or expenses in this case.<sup>23</sup> SWEPCO argues that Dolet Hills will be providing service to customers at the beginning of the rate year and that this will result in non-fuel O&M billings.<sup>24</sup> However, SWEPCO acknowledges that 16 TAC § 25.231(b) refers to adjustments to operating revenues and expenses and that SWEPCO has incorporated numerous adjustments for known and measurable changes in its requested revenue requirement under this section.<sup>25</sup>

Notably, SWEPCO's own proposal with respect to Dolet Hills deviates from 16 TAC § 25.231(c)(2)(F)(iii) by reducing the Dolet Hills plant balance in rate base, and Staff's recommendation was made in response to SWEPCO's proposal.<sup>26</sup> Ms. Stark notes that the Commission frequently makes exceptions to its rules and she assumed SWEPCO was requesting an exception to the rule by making its own contrary proposal.<sup>27</sup>

Ms. Stark recommends that early retirement of Dolet Hills be addressed in a manner similar to the way the Commission treated the early retirement of SWEPCO's Welsh Unit 2 in Docket No.

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<sup>22</sup> *Id.* at Attachment RS-31

<sup>23</sup> SWEPCO Ex. 36 at 7:10 – 8:2

<sup>24</sup> Staff Ex. 3 at Attachment RS-30.

<sup>25</sup> *Id.* at Attachment RS-32.

<sup>26</sup> Tr. 410:4-6 (Stark Cross) (May 20, 2021).

<sup>27</sup> Tr. 418:2-7 (Stark Re-direct) (May 20, 2021).

46449, rather than SWEPCO's proposal to treat it as the Commission did in the prior case, Docket No. 40443.<sup>28</sup> In addressing the treatment of SWEPCO's retired Welsh Unit 2 plant in Docket No. 46449, the Commission made the following findings:

65. SWEPCO retired Welsh unit 2 in April of 2016.<sup>29</sup>

66. Welsh unit 2 no longer generates electricity and is not used by and useful to SWEPCO in providing electric service to the public.<sup>30</sup>

67. Under the FERC uniform system of accounts, the appropriate accounting treatment for the retirement is to credit plant in service with the original cost of the Welsh unit 2 and debit accumulated depreciation with the same amount. This would leave a debit balance in accumulated depreciation equal to the undepreciated balance of Welsh unit 2.<sup>31</sup>

68. Because Welsh unit 2 is no longer used and useful, SWEPCO may not include its investment associated with the plant in its rate base, and may not earn a return on that remaining investment.<sup>32</sup>

69. Allowing SWEPCO a return of, but not on, its remaining investment in Welsh unit 2 balances the interests of ratepayers and shareholders with respect to a plant that no longer provides service.<sup>33</sup>

70. It is reasonable for SWEPCO to recover the remaining undepreciated balance of Welsh unit 2 over the 24-year remaining lives of Welsh units 1 and 3.<sup>34</sup>

71. The appropriate accounting treatment that results in the appropriate ratemaking treatment is to record the undepreciated balance of Welsh unit 2 in a regulatory-asset account.<sup>35</sup>

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<sup>28</sup> Staff Ex. 3 at 24:10-13.

<sup>29</sup> Docket No. 46449, Order on Rehearing, Finding of Fact No. 65 (Mar. 19, 2018).

<sup>30</sup> *Id.* at Finding of Fact No. 66.

<sup>31</sup> *Id.* at Finding of Fact No. 67.

<sup>32</sup> *Id.* at Finding of Fact No. 68.

<sup>33</sup> *Id.* at Finding of Fact No. 69.

<sup>34</sup> *Id.* at Finding of Fact No. 70.

<sup>35</sup> *Id.* at Finding of Fact No. 71.

Ms. Stark explains that, although Welsh Unit 2 was retired prior to the end of the test year in Docket No. 46449 while the Dolet Hills plant is still in service, the Dolet Hills plant will be retired during the rate year associated with this proceeding, which was not the case with Welsh Unit 2 in Docket No 40443.<sup>36</sup> Dolet Hills will be retired approximately two months after the Commission is anticipated to issue its final order in this proceeding and this calls for the Commission to address the retirement of Dolet Hills in this case, not four years from now when SWEPCO would have recovered in excess of \$138 million from its ratepayers for a plant that did not provide service to them for the entirety of that time period, less two months.<sup>37</sup>

Further, Ms. Stark explains that there are other factors that support her proposed treatment of the early retirement of Dolet Hills, including the fact that approximately 39% of the ending test year balance of the plant is related to environmental retrofits that were recently placed into rates in Docket No. 46449 and were expected to be recovered through 2046, as opposed to the compressed four-year period now proposed by SWEPCO.<sup>38</sup> Additionally, Ms. Stark notes that Dolet Hills is not the only plant SWEPCO is planning to retire early as SWEPCO has announced that it is planning to retire its H.W. Pirkey power plant early as well, estimating that Pirkey will cease burning coal by March 31, 2023.<sup>39</sup> This is approximately halfway through the estimated four-year period that rates from this case are expected to be in effect.<sup>40</sup> SWEPCO identifies \$57,206,148 as included in its revenue requirement in this proceeding related to Pirkey, and those costs will continue to be in SWEPCO's rates until changed in the next base rate case.<sup>41</sup> Ms. Stark does not recommend any adjustments be made to SWEPCO's revenue requirement related to Pirkey in this proceeding, but she does recommend that the Commission order SWEPCO to file earnings monitoring reports every six months beginning six months after the date Pirkey is retired and continuing until it files its next base rate case to ensure that any potential overearnings related to the plant's early retirement are dealt with in a timely manner.<sup>42</sup>

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<sup>36</sup> Staff Ex. 3 at 24:13-16.

<sup>37</sup> *Id.* at 24:16-21.

<sup>38</sup> *Id.* at 26:4-12.

<sup>39</sup> *Id.* at Attachment RS-35.

<sup>40</sup> *Id.* at 27:6-8.

<sup>41</sup> *Id.* at Attachment RS-36.

<sup>42</sup> *Id.* at 28:4-7.

Additionally, there are other ways the Commission could address the early retirements of Dolet Hills and Pirkey in this case. Ms. Stark notes that the Commission's final order in this proceeding, expected to be issued in late 2021, could include a requirement that SWEPCO file another rate case in June 2022 using a December 2021 test-year end and a subsequent case in September 2023 using a March 31, 2023 test year end to coincide with the plant retirement dates.<sup>43</sup> While these proceedings would necessitate the accrual of rate-case expenses, given the costs of prior proceedings, Ms. Stark expects that those expenses should still be considerably lower than the costs of Dolet Hills and Pirkey being included in SWEPCO's requested revenue requirement in this case.<sup>44</sup> The Commission, at its discretion, can determine the appropriate time for the filing of SWEPCO's next rate case based on its filed earnings monitoring reports.<sup>45</sup> As another option, the Commission could order SWEPCO to begin recording regulatory liabilities for the costs included in the revenue requirement associated with Dolet Hills and Pirkey in this case commencing on the retirement dates of each plant.<sup>46</sup> Finally, the Commission's order in this proceeding could require a step-down of SWEPCO's rates in January 2022 and April 2023 to recognize the early retirement of those two plants.<sup>47</sup>

Overall, Staff's recommendation in this proceeding provides SWEPCO the opportunity to recover its full cost of service for operating Dolet Hills for the period that it will actually be providing service to ratepayers. Additionally, Staff's recommendation reflects the Commission precedent with respect to retired plants that are no longer used and useful once the plant is retired, provides for refunds to ratepayers of the amounts owed to them by SWEPCO because of the tax rate decreases of the TCJA, and provides for monitoring SWEPCO's earnings once Pirkey is retired to timely address any potential overearnings associated with SWEPCO removing that plant from service.<sup>48</sup> Staff's recommendation is fair to both SWEPCO and its ratepayers and provides

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<sup>43</sup> *Id.* at 28:10-13.

<sup>44</sup> *Id.* at 28:13-16.

<sup>45</sup> *Id.* at 28:16-18.

<sup>46</sup> *Id.* 28:18-21.

<sup>47</sup> *Id.* at 28:21-23.

<sup>48</sup> *Id.* at 29:1-8.

flexibility with respect to the retirement of the Pirkey plant.<sup>49</sup> Thus, Staff recommends that its proposal regarding both the Dolet Hills and Pirkey plants be adopted in the PFD.

## **2. Retired Gas-Fired Generating Units [PO Issue 13]**

Staff urges the ALJs to adopt Staff's position regarding the retired gas-fired generating units, including that (1) the net book value of the retired plants be placed in a regulatory asset and amortized over the four-year period that rates from this case are expected to be in effect; (2) that an adjustment of \$3,310,118 to amortization expense be made; (3) that SWEPCO be allowed a return on but not off its investment on the plants; and (4) a related adjustment of (\$464,939) to depreciation expense be made.

SWEPCO explains that since its last base rate case filed in 2016, Docket No. 46449, five generating units have been retired:

<u>Unit</u>	<u>Retirement Date</u>
Knox Lee Unit 4	January 2019
Knox Lee Unit 2	May 2020
Knox Lee Unit 3	May 2020
Lieberman Unit 2	May 2020
Lone Star Unit 1	May 2020 <sup>50</sup>

SWEPCO reflects an adjustment of (\$616,316) to remove the operations and maintenance expenses associated with these recently retired generating units from its cost of service.<sup>51</sup> SWEPCO does not propose any additional adjustments to rate base related to the retirements. Ms. Stark explains that it is reasonable to treat these retired generating units in a manner consistent with the regulatory treatment established in Docket No. 46449, described above, and remove \$13,240,470 of net book value related to these plants from rate base.<sup>52</sup> Commission precedent established in Docket No. 46449 called for amortizing Welsh Unit 2 over the remaining lives of

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<sup>49</sup> *Id.* at 29.8-10.

<sup>50</sup> Direct Testimony of Monte McMahon, SWEPCO Ex. 7 at 9:7-10.

<sup>51</sup> *Id.* at 21:1-2.

<sup>52</sup> Staff Ex. 3 at 19.9-12.

the two Welsh units that remained in service (Units 1 and 3).<sup>53</sup> According to Ms. Stark, the retired units were not retired early but rather were, at the end of their estimated useful lives as established in Docket No. 46449. She therefore recommends that the net book value of the retired plants be placed in a regulatory asset and amortized over the four-year period that rates from this case are expected to be in effect.<sup>54</sup> Staff recommends an adjustment of \$3,310,118 to amortization expense to recognize this amortization.<sup>55</sup> Ms. Stark notes that in aggregate, Staff's proposed adjustments provide for a return of, but not on, SWEPCO's remaining investment in these units consistent with Commission precedent in Docket No. 46449.<sup>56</sup> Staff also recommends a related adjustment of (\$464,939) to depreciation expense to exclude the depreciation expense related to these plants in SWEPCO's requested revenue requirement, and the removal of the net book value of the retired units from the plant balance used to calculate ad valorem taxes.<sup>57</sup>

### **C. Accumulated Deferred Federal Income Tax [PO Issues 20]**

#### **1. Net Operating Loss ADFIT**

The ALJs should reject SWEPCO's claim that it can add \$455,122,490 to its rate base for a NOLC ADFIT asset that is no longer on its books. This asset should be removed from its requested rate base and no return on this asset should be charged to customers as a part of SWEPCO's revenue requirement.

SWEPCO claims that it is in a net operating loss position on a stand-alone basis for federal income tax purposes.<sup>58</sup> SWEPCO participates in the AEP, Inc. consolidated federal income tax return and, pursuant to the AEP, Inc. tax sharing agreement<sup>59</sup>, was paid \$455,122,490 for the use of its tax losses by its parent and affiliates.<sup>60</sup> The receipt of these payments under the tax sharing agreement reduced the balance of SWEPCO's NOLC ADFIT to \$0 on its actual books and records

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<sup>53</sup> Docket No. 46449, Order on Rehearing, Finding of Fact No. 70.

<sup>54</sup> Staff Ex. 3 at 19:19-23.

<sup>55</sup> *Id.* at 19:23 – 20:1.

<sup>56</sup> *Id.* at 20:1-3.

<sup>57</sup> *Id.* at 20:3-6

<sup>58</sup> Direct Testimony of David Hodgson, SWEPCO Ex. 17 at 27:11-14.

<sup>59</sup> SWEPCO's Response to Staff's Ninth Request for Information at Staff 9-17, Staff Ex. 41.

<sup>60</sup> Staff Ex. 3 at 38:3-6.

in accordance with generally accepted accounting principles (GAAP) and the Federal Energy Regulatory Commission (FERC) uniform system of accounts.<sup>61</sup> SWEPCO claims that it seeks to add the \$455,122,490 NOLC deferred tax asset (DTA) associated with its stand-alone net operating losses back to its rate base in this case because doing so is consistent with PURA § 36.060 and the IRS normalization rules.<sup>62</sup> Contrary to SWEPCO's claim, SWEPCO's treatment of the NOLC DTA is not consistent with either PURA § 36.060 nor the IRS normalization rules and thus the NOLC DTA should be removed from SWEPCO's rate base.

***Staff's interpretation is consistent with PURA § 36.060***

SWEPCO's request to put the NOLC DTA in rate base is a departure from the stand-alone calculation of federal income tax expense and the associated ADFIT that has previously been used in SWEPCO's prior rate cases and has a substantial impact on regulatory ratemaking in this case.<sup>63</sup> For instance, in SWEPCO's last base rate case, Docket No. 46449, SWEPCO's records at the end of the test year reflected a NOLC ADFIT of \$0 as a result of SWEPCO's participation in the AEP, Inc. consolidated tax sharing agreement, as is the case in this proceeding, and no adjustments were made by SWEPCO in Docket No. 46449 to reflect the level of NOLC ADFIT on a separate return basis.<sup>64</sup> In Docket No. 46449, SWEPCO witness J. David Spring correctly testified that SWEPCO's federal income tax was calculated on a stand-alone basis and that its actual NOLC ADFIT was \$0.<sup>65</sup> SWEPCO now seeks to redefine the stand-alone basis of determining income tax expense in a novel way, by reaching back and changing how tax losses that were incurred prior to the end of the test year of a previous case should be treated for ratemaking purposes.<sup>66</sup> This reach back includes an attempt to claw back tax losses that occurred prior to SWEPCO's last base rate case in Docket No. 46449. Ms. Stark determined that \$388,968,550 of the \$455,122,490 that SWEPCO seeks to add to its rate base in this case would have existed as of the end of the test year

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<sup>61</sup> SWEPCO's Response to Staff's Seventeenth Request for Information at Staff 17-8, Staff Ex. 34; SWEPCO's Response to Staff's Seventeenth Request for Information at Staff 17-9, Staff Ex. 35.

<sup>62</sup> SWEPCO Ex. 17 at 28:10-12.

<sup>63</sup> Staff Ex. 3 at 33:15-22

<sup>64</sup> Staff Ex. 3 at 34:1-19; SWEPCO's Response to Staff's Ninth Request for Information at 9-21, Staff Ex. 43.

<sup>65</sup> Docket No. 46449, Direct Testimony of J. David Spring (Oct. 17, 2016), Staff Ex. 45 at 18:4-7.

<sup>66</sup> Staff Ex. 3 at 35:6-7.

in Docket No. 46449 leaving just \$66,153,940 related to tax years after the Docket No. 46449 test year.<sup>67</sup> SWEPCO is not entitled to put any of the \$455,122,490 into rate base, including the \$66,153,940 related to tax years subsequent to the test year for Docket No. 46449.

SWEPCO asserts that using its actual book NOLC ADFIT balance of \$0 for ratemaking purposes creates “an operational economic risk with the rate regulation associated with including a consolidated return adjustment into the rates of utility companies.”<sup>68</sup> Here, SWEPCO’s claim is that using its actual books and records, which reflects a NOLC ADFIT balance of \$0 to set rates creates operational economic risk for SWEPCO. SWEPCO’s claim lacks support,, as it implies that SWEPCO’s own treatment of the NOLC ADFIT in its actual books of \$0 somehow harms SWEPCO.

Further, SWEPCO witness David Hodgson claims that Staff’s recommendation to exclude the NOLC ADFIT asset from rate base is akin to a consolidated tax savings adjustment (CTSA) that was prohibited by the Texas legislature and is inconsistent with PURA § 36.060(a).<sup>69</sup> Staff witness Ms. Stark explains that this claim made by SWEPCO is categorically false and that including the actual test-year-end balance of SWEPCO’s NOLC ADFIT of \$0 is not a CTSA akin to the adjustments to rates recognized by the Commission prior to the changes to PURA § 36.060 in 2013.<sup>70</sup> The amended section of PURA § 36.060 states in part:

Sec. 36.060 CONSOLIDATED INCOME TAX RETURNS

- (a) If an expense is allowed to be included in utility rates or an investment is included in the utility rate base, the related income tax benefit must be included in the computation of income tax expense to reduce the rates. If an expense is not allowed to be included in utility rates or an investment is not included in the utility rate base, the related income tax benefit may not be included in the computation of income tax expense to reduce the rates. The income tax expense shall be computed using the statutory income tax rates.

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<sup>67</sup> *Id.* at 34:22 – 35:11.

<sup>68</sup> Staff Ex. 3 at 38:11 – 39:2; Staff Exhibit 43.

<sup>69</sup> Rebuttal Testimony of David Hodgson, SWEPCO Exhibit 45 at 2:26-34 to 3:1-13.

<sup>70</sup> Staff Ex. 3 at 36:8-10.



While the title of the section is “consolidated income tax returns,” the plain text of the statute does not mention consolidated returns. The section merely addresses the inclusion or exclusion of expenses in rates and investment in rate base, and the treatment of the related tax benefits in the computation of federal income tax expense to reduce rates. As explained by the Author’s/Sponsor’s Statement of Intent in the Bill Analysis:

Section 36.060(a), Utilities Code, has been interpreted to require the Public Utility Commission of Texas to implement a consolidated tax savings adjustment in rate proceedings involving an electric utility that is part of an affiliated group eligible to file a federal consolidated income tax return. Current law allows the comingling of electric utility and non-electric utility costs. This comingling violates legislative intent that the activities of an electric utility’s affiliates should not affect the utility service provided to ratepayers or the rates that they pay for such services.<sup>71</sup>

The prior interpretation of PURA, referenced above, required CTSAs to reflect the tax losses of utility affiliates in rates through the use of the tax shield or interest credit methodology.<sup>72</sup> These CTSAs were a mathematical calculation that took the tax losses of the utility’s affiliated group for the prior 15 years that would not have been realized by its affiliates as of the test year but for their affiliation with the regulated utility, multiplied them by the time value of money, and used that amount to reduce federal income tax expense of the utility.<sup>73</sup> There was no actual transaction that created the tax shield. As a result, the Commission acknowledged that the utility did not bear the burden of losses from unprofitable affiliates.<sup>74</sup> Nonetheless, the Commission reasoned that the utility’s affiliates received a competitive advantage over competitors and that the utility should be compensated for the value of the tax shield it provides to its affiliates.<sup>75</sup> It is this type of CTSA, the commingling of utility and non-utility activities, that the change to § 36.060 was designed to prohibit.<sup>76</sup> The NOLC ADFIT issue presented in this docket is not related to this

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<sup>71</sup> Bill Analysis for Revisions to PURA § 36.060(a); SWEPCO Exhibit 68 (not offered by SWEPCO into evidence).

<sup>72</sup> *Application of Central Power and Light Company for Authority to Change Rates*, Docket No. 14965, Second Order on Rehearing at Finding of Fact No.112B (Oct. 16, 1997).

<sup>73</sup> *Id.*

<sup>74</sup> *Id.* at Finding of Fact No. 107.

<sup>75</sup> *Id.* at Finding of Fact 112A.

<sup>76</sup> Tr. at 419:8-11 (Stark Re-direct) (May 20, 2021).

type of CSTA, or the type of tax-related issue that was contemplated by the change to PURA § 36.060.

There is nothing in the amended version of PURA § 36.060 that prevents the Commission from recognizing actual financial transactions with true economic substance even if those transactions are the result of a consolidated tax return.<sup>77</sup> Further, it does not require the Commission to ignore the actual operating results of SWEPCO as recognized by GAAP and FERC accounting.<sup>78</sup> Further, the statute does not say that the Commission is required to ignore the true economic costs of the utility.<sup>79</sup> In fact, the parties that supported the changes to PURA § 36.060 (which included the Association of Electric Companies of Texas, Inc. of which SWEPCO is a member<sup>80</sup>) stated that “[t]he bill would ensure that true economic costs were reflected in a utility’s rates . . . .”<sup>81</sup> Staff unequivocally agrees with the Association of Electric Companies of Texas, Inc. that true economic costs should be reflected in a utility’s rates. In this docket, there were transactions amounting to \$455,122,490 of real economic substance between SWEPCO and AEP, Inc. related to AEP, Inc.’s use of SWEPCO’s tax losses and SWEPCO’s use of the cash it received from AEP, Inc. to finance plant assets that are included in its rate base.<sup>82</sup>

SWEPCO records its stand-alone tax NOLC ADFIT on both its GAAP and FERC books.<sup>83</sup> For the period 2009 through the end of the test year, March 31, 2020, SWEPCO calculated this amount by multiplying its taxable income or taxable loss each year by the tax rate in effect for that year, which totals \$455,122,490.<sup>84</sup> Additionally, SWEPCO either received or made payments in these amounts each year under the tax allocation agreement, which equals \$455,122,490 of net

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<sup>77</sup> PURA § 36.060(a).

<sup>78</sup> PURA § 36.060(a).

<sup>79</sup> PURA § 36.060(a).

<sup>80</sup> See Application of SWEPCO for Authority to Change Rates, SWEPCO Ex. 1 at Schedule G-4.3 Industry Organization Dues.

<sup>81</sup> Workpapers to the Rebuttal Testimony of David Hodgson, SWEPCO Ex. 45A, WP- 1 at 3.

<sup>82</sup> Staff Ex. 3 at 39:17-19.

<sup>83</sup> SWEPCO’s Response to Staff’s Seventeenth Request for Information at Staff 17-7, Staff Exhibit 33; Staff Ex. 34; Staff Ex. 35.

<sup>84</sup> SWEPCO’s Response to Staff’s Seventeenth Request for Information at 17-11, Staff Ex. 37 at Attachment 1.

payments received by SWEPCO.<sup>85</sup> SWEPCO witness Mr. Hodgson testified that the payments were generally made and received quarterly when the federal tax estimated payments occurred.<sup>86</sup>

Staff witness Ms. Stark testified that because of these payments, SWEPCO no longer has the NOLC ADFIT on its books and, just like the sale or disposition of any other asset, SWEPCO should not be allowed to earn a return on an asset for which it received cash compensation.<sup>87</sup> The NOLC ADFIT is therefore not properly included in SWEPCO's rate base.<sup>88</sup> The fact that this transaction is the result of a tax sharing agreement does not require it to be treated differently than other transactions related to any other assets that are sold or traded for cash compensation and that are appropriately reflected in SWEPCO's rates by PURA or the Commission's substantive rules.<sup>89</sup> As stated previously, PURA § 36.060 does not prohibit the recognition of real economic transactions that have real financial impacts, such as the receipt of over \$455,122,490 million in cash for a tax asset.<sup>90</sup>

Further evidence that the Commission should reject the SWEPCO's proposal is the fact that SWEPCO acknowledged for the first time in its rebuttal testimony that the \$455,122,490 of cash received through the tax allocation agreement reduced the otherwise needed capital to fund prudent plant investment. As a result, SWEPCO needed less capital through debt and equity than it would have required absent the cash received through the tax allocation agreement.<sup>91</sup> SWEPCO is therefore seeking a debt and equity return on assets that were financed not by its own debt and equity capital, but by the tax attributes of its affiliates.<sup>92</sup> SWEPCO's current rates, set in Docket

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<sup>85</sup> Staff Exhibit 37 at Attachment 1 (\$147,873,618 payments + (\$602,996,108) receipts = (\$455,122,490) net receipts by SWEPCO).

<sup>86</sup> Tr. at 272:9-11 (Hodgson Redirect) (May 19, 2021).

<sup>87</sup> Staff Ex. 3 at 39:23 – 40:4.

<sup>88</sup> *Id.*

<sup>89</sup> PURA 36.060; 16 TAC § 25.231.

<sup>90</sup> PURA § 36.060.

<sup>91</sup> SWEPCO Ex. 45 at 15:1-5.

<sup>92</sup> Tr. at 394:14-16 (Stark Cross) (May 20, 2021).

No. 46449, include assets that were financed by the tax allocation payments received for the tax attributes of SWEPCO's affiliates and not by its own debt and equity capital.<sup>93</sup>

SWEPCO had \$455,122,490 of NOLC ADFIT that SWEPCO exchanged for cash, which it then used to finance \$455,122,490 of plant assets that are included in rate base.<sup>94</sup> As a result of financing plant assets with the cash received for the tax attributes of its affiliates, SWEPCO essentially exchanged the \$455,122,490 NOLC ADFIT that was previously recorded in its rate base for \$455,122,490 in plant assets that are now included in its rate base.<sup>95</sup> This interpretation of PURA § 36.060 is consistent with the stand-alone tax calculation used by the Commission to set SWEPCO's current rates,<sup>96</sup> recognizes SWEPCO's true economic costs,<sup>97</sup> and does not result in either an increase or decrease in rates because of the consolidated tax return.<sup>98</sup>

On the other hand, SWEPCO's interpretation of PURA § 36.060 and its newly proposed version of a stand-alone tax calculation results in an increase in SWEPCO's rates merely because of the filing of the consolidated tax return and participation in the tax sharing agreement.<sup>99</sup> SWEPCO is asking its customers to pay an additional amount of return and associated taxes equivalent to what it would pay on a power plant for an asset for which it has already been fully compensated and therefore has been removed from its actual books.<sup>100</sup> As a frame of reference, SWEPCO's amended request in this case is a Texas jurisdictional base rate increase of \$85.2 million.<sup>101</sup> In Docket No. 40443, where SWEPCO sought to include in rates a power plant that cost in excess of \$1 billion (the Turk plant),<sup>102</sup> SWEPCO's requested rate increase on a Texas

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<sup>93</sup> Tr. at 420:4-7 (Stark Re-direct) (May 20, 2021).

<sup>94</sup> Tr. at 394:10-14 (Stark Cross) (May 20, 2021).

<sup>95</sup> Tr. at 392:19-23 (Stark Cross) (May 20, 2021).

<sup>96</sup> Staff Ex. 3 at 33:15-22.

<sup>97</sup> *Id.* at 39:17-19.

<sup>98</sup> Tr. at 420:24 – 421:3 (Stark Re-direct) (May 20, 2021).

<sup>99</sup> Tr. at 420:18-23 (Stark Re-direct) (May 20, 2021).

<sup>100</sup> Staff. Ex. 3 at 40:20-22.

<sup>101</sup> SWEPCO Ex. 36 at MAB-1R.

<sup>102</sup> *Application of Southwestern Electric Power Company for Authority to Change Rates and Reconcile Fuel Costs*, Docket No. 40443, Order on Rehearing at Finding of Fact No. 116A (Mar. 6, 2014)

jurisdictional basis was \$83 million.<sup>103</sup> Allowing SWEPCO to include the \$455,122,490 of assets financed by the NOLC ADFIT and also adding the \$455,122,490 NOLC ADFIT back to rate base results in SWEPCO earning a return twice on the same \$455,122,490.<sup>104</sup> As Ms. Stark testified, this results from SWEPCO picking one item of a theoretical stand-alone calculation and failing to recognize the offsetting impact of adding the NOLC ADFIT back to rate base.<sup>105</sup>

This selectiveness in the theoretical stand-alone calculation is made clear by reviewing the “Regulatory Ratemaking Journal Entries” that SWEPCO supposedly used to add the NOLC ADFIT to its test-year end book balances.<sup>106</sup> SWEPCO claims that it rebooked the NOLC ADFIT to its regulatory books by debiting the NOLC ADFIT account by a net amount of \$455,122,590 and crediting the same net amount to “Debt/Equity” as follows:<sup>107</sup>

Description	Account	Debit	Credit
Deferred Tax Asset - NOL	1901001	486,133,877	
Debt/Equity			486,133,877
Debt/Equity		31,011,387	
Deferred Tax Asset - NOL	1901001		31,011,387
Net			
Deferred Tax Asset - NOL	1901001	455,122,490	
Debt/Equity			455,122,490

However, Ms. Hawkins, the SWEPCO witness responsible for sponsoring its proposed capital structure (i.e., debt and equity) in this proceeding, admitted that she was not familiar with these journal entries being included in Schedule K-1, the schedule where the debt and equity for

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<sup>103</sup> *Id.* at Finding of Fact No. 5.

<sup>104</sup> Tr. at 394:16-21 (Stark Cross) (May 20, 2021).

<sup>105</sup> Tr. at 393:19-24 (Stark Cross) (May 20, 2021).

<sup>106</sup> SWEPCO Ex. 1 at WP B-1.5.17 (Dolet ADFIT Offset), tab titled “NOL Excess Entries” JE Nos. 1 and 3.

<sup>107</sup> *Id.*

SWEPCO is reflected.<sup>108</sup> Ms. Hawkins also admitted that the \$455,122,490 was not reflected as an adjustment to debt and equity on Schedule K-1<sup>109</sup> and a review of Schedule K-1 does not show adjustments to debt and equity in an amount similar to \$455,122,490 in the pro forma adjustment column.<sup>110</sup> Most significantly, Ms. Hawkins testified that putting the NOLC ADFIT in rate base does not create debt and equity<sup>111</sup>

Ms. Stark testified that the correct offsetting entry to reflect the NOLC ADFIT in rate base is to remove the assets that were financed with the proceeds from the NOLC ADFIT.<sup>112</sup> As Ms. Stark indicated in her testimony, debits equal credits and the balance sheet balances, but SWEPCO is only seeking to reflect one half of the regulatory ratemaking journal entries in rates in this proceeding, and SWEPCO should not be able to recognize one part of the entry without recognizing the other because the NOLC ADFIT and the assets financed with the cash SWEPCO received for the NOLC ADFIT are connected.<sup>113</sup>

As explained above, there are two ways the Commission can interpret PURA § 36.060 and the meaning of a stand-alone tax calculation in this proceeding. Consistent with Staff's proposal, Staff recommends that the ALJs interpret PURA § 36.060 and the meaning of a stand-alone tax calculation as the Commission has interpreted those in the past. Real substantive financial transactions that have real economic impacts, or true economic costs, must be reflected in SWEPCO's rates whether they are the result of a consolidated tax return or not since PURA § 36.060 does not require the Commission to ignore real substantive financial transactions. Alternatively, the ALJs can interpret PURA and the meaning of a stand-alone tax calculation as SWEPCO proposes - so that the real substantive financial transactions that are the consequences of the consolidated tax return have to be removed from SWEPCO's cost of service. If the Commission interprets PURA § 36.060 and the normalization rules in such a manner that SWEPCO must include the NOLC ADFIT in rate base, then the assets financed by the tax

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<sup>108</sup> Tr. at 968:7-9 (Hawkins Re-direct) (May 24, 2021).

<sup>109</sup> Tr. at 968:10-18 (Hawkins Re-direct) (May 24, 2021).

<sup>110</sup> SWEPCO Ex. 1 at Schedule K-1.

<sup>111</sup> Tr. at 968:22-25 (Hawkins Re-direct) (May 24, 2021).

<sup>112</sup> Tr. at 420:18-23 (Stark Re-direct) (May 20, 2021).

<sup>113</sup> Tr. at 420:10-16 (Stark Re-direct) (May 20, 2021).

attributes of its affiliates must be removed from rate its base to avoid SWEPCO earning a double return on the same \$455,122,490 and avoid including assets in rate base assets that were financed by its affiliates and not SWEPCO's own capital, consistent with SWEPCO's new interpretation of a theoretical stand-alone tax calculation.

The interpretation of PURA § 36.060 in the instant proceeding will not only impact SWEPCO but will also impact any Texas utility that files a consolidated tax return, participates in a tax sharing agreement, and finances rate base assets with proceeds from that agreement instead of with their own debt and equity capital. If the Commission adopts SWEPCO's new theoretical stand-alone tax calculation, other utilities would also be required to remove assets from their rate base that were financed not with their own debt and equity capital, but with the funds received through their tax sharing arrangements with their affiliates.

***Staff's interpretation is consistent with the IRS normalization requirements***

Staff urges the ALJ to find that Staff's position regarding removing the NOLC ADFIT asset from SWEPCO's rate base does not create a normalization violation with the Internal Revenue Service (IRS).

Although SWEPCO asserts that it must include the \$455,122,490 NOLC ADFIT in its rate base to avoid a normalization violation, it did not seek a private letter ruling (PLR) from the IRS with respect to the issue of whether it is required to compute its NOLC ADFIT on a separate stand-alone basis.<sup>114</sup> The PLRs provided by SWEPCO in testimony and discovery support the Staff position that there is no normalization violation if the actual book NOLC ADFIT balance of \$0 is reflected in rate base. One particular PLR, No. 201828010,<sup>115</sup> directly addresses the treatment of a reduction of a utility's NOLC ADFIT balance in rate base by a payment from its parent under a tax sharing agreement. In that PLR, an IRS settlement resulting from an audit of the consolidated group caused there to be a reduction of the utility's NOLC ADFIT balance because of a payment from its parent under a tax sharing agreement.<sup>116</sup>

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<sup>114</sup> Staff Ex. 3 at 36:9-11; SWEPCO's Response to OPUC's Third Request for Information at 3-7, Staff Ex. 39.

<sup>115</sup> Rebuttal Testimony of Bradley Seltzer, SWEPCO Ex. 44 at BMS-2R.

<sup>116</sup> *Id.* at BMS-2R at 4.

This PLR notes that an audit of the consolidated tax returns of the consolidated group of which the utility was a member resulted in adjustments to the taxable income of both regulated and non-regulated members of the group.<sup>117</sup> The IRS and the consolidated group entered into a settlement agreement that absorbed a portion of the consolidated NOLC attributable to the utility, and the utility received payments from the group under its tax sharing agreement for the use of its NOLC.<sup>118</sup> These results were recorded on the utility's books "in the appropriate DTA [Deferred Tax Asset] accounts."<sup>119</sup> According to the PLR, "The recordation resulted in a reduction in Taxpayer's NOLC-related DTA. By reducing Taxpayer's DTA, this recordation increased Taxpayer's net ADFIT balance."<sup>120</sup> The IRS refers to this result as "the impact of the IRS Settlement" in its analysis and conclusion in the PLR.

The utility filed rate cases in two of the state jurisdictions in which it operates after recording the adjustments to the NOLC ADFIT DTA balance due to the payments received under the tax sharing agreement.<sup>121</sup> The recordation of the reduction to the NOLC ADFIT DTA occurred in the last month of the test period used for the case in the first state<sup>122</sup> and in the fourth month prior to the end of the test period in the second state.<sup>123</sup> Both states employ a 13-month average to compute rate base and the utility proposed including 1/13 and 4/13, respectively, of the reduction to its NOLC DTA balance (the impact of the IRS settlement) in determining its requested rate base.<sup>124</sup> Intervening parties in both states proposed to reflect the full amount, the end of test period amount, of the reduction (impact of the IRS settlement) in rate base.<sup>125</sup> Thus, the question before the IRS in this PLR is:

Whether the application of a 13-month average regulatory convention to most elements of rate base, including most elements of Taxpayer's ADFIT balance, and

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<sup>117</sup> *Id.*

<sup>118</sup> *Id.*

<sup>119</sup> *Id.*

<sup>120</sup> *Id.*

<sup>121</sup> *Id.*

<sup>122</sup> *Id.*

<sup>123</sup> SWEPCO Ex. 44 at BMS-2R at 5.

<sup>124</sup> SWEPCO Ex. 44 at BMS-2R at 4-5.

<sup>125</sup> *Id.*



the application of a different regulatory convention (end of test period) to the impact of the IRS Settlement is acceptable under the Normalization Rules.<sup>126</sup>

The IRS notes in its analysis that “[i]n order to satisfy the requirements of § 168(i)(9)(B), there must be consistency in the procedures and adjustments used in ratemaking to calculate elements in rate base, depreciation expense, tax expense, and the reserve for deferred taxes.”<sup>127</sup> The IRS further explains that “[i]n this case, the IRS settlement has an effect on Taxpayer’s ADFIT balance and the Taxpayer, along with Commission A and Commission B, agree that the settlement must be taken into account in setting Taxpayer’s rates.”<sup>128</sup> The IRS explained that “the only question is whether the same convention used to calculate other elements of rate base, including ADFIT, a 13-month averaging convention, must also apply to calculate the effect of the IRS Settlement, or whether a different convention may apply to this element.”<sup>129</sup> The IRS concluded that “the application of a 13-month average regulatory convention to most elements of rate base, including most elements of Taxpayer’s ADFIT balance, and the application of a different regulatory convention (end of test period) to the impact of the IRS Settlement is not acceptable under the Normalization Rules.”<sup>130</sup>

In discussing this PLR, SWEPCO witness Mr. Seltzer states that “the parent had made a tax sharing payment to the utility with respect to its NOL and the IRS attached no significance to that in addressing and resolving whether the taxpayer’s methodology complied with the normalization rules”<sup>131</sup> and “surely, if the payments under a tax sharing agreement must be taken into account in determining the allowable Deferred Tax Asset as Staff claim, the IRS could not, and would not, simply ignore the payment to the utility in its analysis.”<sup>132</sup> Mr. Seltzer fails to acknowledge that the whole point of contention in that PLR was the treatment of the tax sharing payment received by the utility that reduced the NOLC (and therefore increased ADFIT) and how

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<sup>126</sup> SWEPCO Ex. 44 at BMS-2R at 5.

<sup>127</sup> SWEPCO Ex. 44 at BMS-2R at 6.

<sup>128</sup> *Id*

<sup>129</sup> *Id*

<sup>130</sup> *Id.*

<sup>131</sup> SWEPCO Ex. 44 at 5:23 – 6:3.

<sup>132</sup> *Id.* at 6:3-6.

much of that reduction should be reflected in rates. This is observable by substituting “tax sharing payment received by the utility that reduced the NOLC ADFIT” for “impact of the IRS Settlement” when reading the PLR.

The facts in this PLR are very similar to the facts in SWEPCO’s case – SWEPCO received payments under the tax sharing agreement for the use of its NOLC DTAs and the recordation of these payments were recorded in the appropriate DTA accounts which resulted in the reduction of the NOLC-related DTA balance to \$0.<sup>133</sup> In noting that the taxpayer and its two different state commissions agreed that the reduction to the NOLC from the tax sharing agreement (the effect of the IRS settlement) should be taken into account in setting rates, the IRS did not say that doing so would be a normalization violation. To use SWEPCO’s words, surely if it were a normalization violation to reduce the NOLC in rate base by the funds received from the tax sharing agreement, the IRS could not and would not simply ignore that and not mention it in its analysis. The IRS did not question the reduction of the NOLC because of the tax sharing payment, only that it was included in rate base at the end-of-period balance as opposed to the 13-month average convention used for the other rate base items. Staff’s proposal to include the end of test period balance of the NOLC deferred tax asset balance of zero, consistent with the end of test period balance used for the other elements of SWEPCO’s rate base therefore complies with the consistency and normalization provisions of the internal revenue code and is consistent with the IRS’s ruling in this PLR.

While the other PLRs provided by SWEPCO in testimony and discovery do not directly address the reduction to the NOLC ADFIT because of a payment under a tax sharing agreement, they nonetheless support Staff’s position that reflecting SWEPCO’s actual book NOLC ADFIT balance of \$0 would not result in a normalization violation. PLR No. 201418024 states the following:

Both Commission and Taxpayer have intended, at all relevant times, to comply with the normalization requirements. Commission has stated that, in setting rates it includes a provision for deferred taxes based on the entire difference between accelerated tax and regulatory depreciation, including situations in which a utility has an NOLC or MTCC. Such a provision allows a utility to collect amounts from

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<sup>133</sup> Staff Ex. 3 at 38:3-6.

ratepayers equal to income taxes that would have been due absent the NOLC and MTCC. Thus, Commission has already taken the NOLC and MTCC into account in setting rates. Because the NOLC and MTCC have been taken into account, Commission's decision to not reduce the amount of the reserve for deferred taxes by these amounts does not result in the amount of that reserve for the period being used in determining the taxpayer's expense in computing cost of service exceeding the proper amount of the reserve and violate the normalization requirements. We therefore conclude that the reduction of Taxpayer's rate base by the full amount of its ADIT account without regard to the balances in its NOLC-related account and its MTCC-related account was consistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.<sup>134</sup>

PURA § 36.059 and 16 TAC § 25.231(b)(1)(D) require that the tax savings derived from liberalized depreciation be normalized (i.e., balanced equitably between present and future ratepayers and between ratepayers and the utility). Ms. Stark explained that the depreciation expense used in calculating federal income taxes is the same as that used in setting rates and that the difference between that and the accelerated depreciation used for tax is recorded as ADFIT.<sup>135</sup> Ms. Stark also testified that the total of the current and deferred taxes are included in cost of service.<sup>136</sup> Additionally, Schedule G-7.6 confirms that there is no reduction for a federal net operating loss in SWEPCO's income tax expense calculation that determines the current and deferred taxes included in cost of service.<sup>137</sup> Therefore, Staff's tax expense calculation provides for the full difference between accelerated and regulatory depreciation to be included in rates without regard to any NOLC, and Staff's inclusion of the actual balance of SWEPCO's NOLC of \$0 is consistent with the normalization rules.

In PLR No. 8904008, the utility's regulator proposed that tax effects of the utility's nonregulated affiliates to be added to the deferred tax reserve and therefore reduce rate base of the utility.<sup>138</sup> The utility claimed this would violate consistency between depreciation expense, tax expense, and the reserve for deferred taxes and that some rate base items would be based on the

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<sup>134</sup> SWEPCO's Response to Staff's Seventeenth Request for Information at Staff 17-1, Staff Ex. 23 at Attachment 2 at 4-5.

<sup>135</sup> Staff Ex. 3 at 30:13-20.

<sup>136</sup> Tr. 390:6-7 (Stark Cross) (May 20, 2021).

<sup>137</sup> SWEPCO Ex. 1 at Schedule G-7.6.

<sup>138</sup> SWEPCO Ex. 44 at BMS-1R at 2.

utility alone while others would be based on a combination of taxpayer with other companies in the consolidated group.<sup>139</sup> The IRS ruled that using the tax losses of affiliates would create an excess deferred tax reserve that would reduce rate base to an amount less than needed to meet normalization requirements.<sup>140</sup> The IRS also ruled that using tax losses of affiliates to determine deferred taxes but ignoring them for purposes of determining other components of rate base and cost of service would violate the normalization rules.<sup>141</sup> In this PLR, the regulator was imputing tax losses of affiliates to reduce the utility's rate base. In this case, it is SWEPCO's tax losses at issue, not losses of its affiliates, and Staff proposes that only SWEPCO's actual economic costs be included in rate base. Additionally, because the funds received from the tax allocation agreement for the use of SWEPCO's NOLC ADFIT were used to finance other assets, SWEPCO's rate base is not lower than it would be based on if the utility's NOLC ADFIT is included in rate base alone rather than having assets financed by the NOLC ADFIT, as discussed above.

Finally, the PLRs attached to SWEPCO witness Mr. Hodgson's direct testimony do not address inclusion of a stand-alone NOLC ADFIT as opposed to the consolidated NOLC ADFIT even though almost all of the utilities that requested the PLRs were members of a consolidated group.<sup>142</sup> Mr. Seltzer agrees with Staff that these PLRs do not expressly address the impact of tax sharing agreement payments and that the normalization rules do not require that such payments be ignored for ratemaking purposes.<sup>143</sup> The normalization provisions of the internal revenue code do not use the term "stand-alone."<sup>144</sup> Additionally, Ms. Stark testifies that the IRS considers a consolidated group as a single entity and the fact that the PLRs do not discuss calculating the NOLC on a stand-alone basis for members of a consolidated group supports the Commission reflecting SWEPCO's actual NOLC ADFIT balance of \$0 to set rates because all of SWEPCO's losses did actually defer taxes for the AEP consolidated group by \$455,122,490.<sup>145</sup> Mr. Seltzer

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<sup>139</sup> *Id.*

<sup>140</sup> SWEPCO Ex. 44 at BMS-1R at 4.

<sup>141</sup> SWEPCO Ex. 44 at BMS-1R at 5.

<sup>142</sup> Staff Ex. 3 at 32:3-20.

<sup>143</sup> SWEPCO Ex. 44 at 5:19-22.

<sup>144</sup> 18 CFR § 35.24.

<sup>145</sup> Staff Ex. 3 at 32:22 – 33 :14.

also acknowledges that the parent of the consolidated group is the taxpayer that is relevant to the IRS.<sup>146</sup> Using Mr. Seltzer's words, the IRS attached no significance to the stand-alone NOLC versus consolidated group NOLC in addressing and resolving whether exclusion complied with the normalization rules and surely, if the stand-alone NOLC must be taken into account in determining the allowable NOLC ADFIT (as opposed to the consolidated group's NOLC position), the IRS could not, and would, not simply ignore the stand-alone issue in its analysis, especially if the utility's NOLC has been completely utilized to offset consolidated taxable income as in the case of SWEPCO's NOLC.

Each of these PLRs support Staff's position that there is no normalization violation by including SWEPCO's actual test-year end NOLC ADFIT balance of \$0 in rate base:

- Neither the IRC nor the SWEPCO-cited PLRs require consideration of the NOLC on a stand-alone basis.
- The Commission includes the full amount of the difference between tax and regulatory depreciation expense in cost of service without any reduction for the NOLC, so SWEPCO's rates have already taken its NOLC into account.
- SWEPCO used the funds it received from the tax allocation agreement to finance plant assets so its rate base is neutral with respect to the consolidated tax return and its level is not below what would be required for normalization purposes.
- The IRS has allowed recognition of a reduction to NOLC ADFIT due to a tax allocation agreement payment, only requiring that it be treated in a manner consistent with other elements of rate base. Staff's proposal treats all elements of SWEPCO's rate base, including the reduction to its NOLC ADFIT due to the tax allocation agreement payment, in a consistent manner.

Consistent with the recommendation of Ms. Stark, the Commission should not consider SWEPCO's request to deviate from prior practice without first receiving a PLR from the IRS ruling that such a departure is actually required based on the specific facts and circumstances of SWEPCO and the AEP, Inc. consolidated group.<sup>147</sup> Additionally, the Commission should order that if SWEPCO decides to seek such a PLR, it should do so only in collaboration with

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<sup>146</sup> SWEPCO Ex. 44 at 6:23 – 7:1.

<sup>147</sup> Staff Ex. 3 at 41:20 – 42:2.

Commission Staff.<sup>148</sup> If SWEPCO receives a PLR that supports its position with respect to inclusion of the NOLC ADFIT in rate base, the Commission must also remove the assets financed by the NOLC ADFIT from rate base as described above in Section II.C.1.

In summary, Staff's recommendation to reflect SWEPCO's actual book NOLC ADFIT balance of \$0 is consistent with PURA § 36.060, and the Commission's accepted stand-alone method of calculating tax expense and rate base, reflects SWEPCO's true economic costs in rate base, prevents SWEPCO from earning a return on the same \$455 million twice, and is consistent with the IRC normalization rules. GAAP and FERC accounting also support the reduction of ADFIT by the cash payments received by SWEPCO for its tax losses under the AEP, Inc. tax sharing agreement, and this treatment is not inconsistent with the IRS PLRs identified above. Staff's recommendation protects the public interest inherent in rates and assures that SWEPCO's rates are just and reasonable to its consumers and itself consistent with PURA § 11.002(a).<sup>149</sup>

Finally, regarding SWEPCO's requested NOLC ADFIT, Staff notes Attachment 1 to SWEPCO's response to Staff RFI 17-11<sup>150</sup> shows that the majority of the \$455,122,490 that SWEPCO seeks to include as stand-alone NOLC ADFIT is calculated using the former 35% tax rate and not the current enacted tax rate of 21%.<sup>151</sup> The rebuttal testimony of Mr. Hodgson states that "[i]f the statutory tax rate changes, the ADFIT is revalued to reflect the liability at the new tax rate."<sup>152</sup> The numerical examples in Mr. Hodgson's rebuttal testimony all reflect that the NOLC is recalculated and restated at the new tax rate the same way the rest of ADFIT is recalculated and restated.<sup>153</sup> This may have been an oversight on SWEPCO's part, but nonetheless, SWEPCO has not explained how the net stand-alone accumulated taxable losses of (\$1,241,280,663) could produce \$455,122,490 of future tax benefits when (\$1,241,280,663) multiplied by the enacted tax rate of 21% only equals (\$260,668,939). SWEPCO seems to acknowledge that the balance of the NOLC should be restated to reflect the change in tax rate in the "Regulatory Ratemaking

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<sup>148</sup> *Id.* at 42:2-4.

<sup>149</sup> *Id.* at 41:13-16.

<sup>150</sup> Staff Exhibit 37.

<sup>151</sup> Staff Exhibit 37. Refer to the column labeled "Tax Rate."

<sup>152</sup> SWEPCO Ex. 45 at 20:19-20.

<sup>153</sup> *Id.* at 22-24.

Journal Entries” related to the NOLC ADFIT at WP B-1.5.17 discussed previously.<sup>154</sup> It appears that SWEPCO is showing a reduction to the NOLC ADFIT by an amount of \$194,453,551 and creating what SWEPCO labels as a regulatory “asset” (actually, a contra-regulatory liability in account 254) for the same amount.<sup>155</sup> SWEPCO has not provided any support for this “regulatory asset” or provided any evidence or support for why this portion of ADFIT should be calculated differently than the rest of ADFIT. Therefore, it appears that SWEPCO’s requested stand-alone NOLC ADFIT is overstated by \$194,453,551 (\$455,122,490 minus \$260,668,939). Staff therefore recommends that if SWEPCO’s position is adopted in the PFD regarding the NOLC ADFIT asset, which Staff continues to argue is the incorrect treatment, that the asset’s impact on rate base should be reduced from \$455,122,490 to \$260,668,939 to reflect the reduction in the enacted tax rate.

In conclusion, Staff argues that (1) the \$455,122,490 for the NOLC ADFIT asset should be removed from rate base; (2) that Staff’s position does not create a normalization violation with the IRS; and (3) even if the ALJs find that the NOLC ADFIT should be put in rate base it should be adjusted down to \$260,668,939 to reflect the current corporate tax rate of 21%.

## **2. Excess ADFIT**

### ***Refund of Excess ADFIT amortization since January 1, 2018***

Staff urges the ALJs to reject SWEPCO’s proposal to offset its remaining balance of the Dolet Hills plant with the excess ADFIT owed to ratepayers resulting from the TCJA and instead, require SWEPCO to refund the total amount of the excess ADFIT to ratepayers by first crediting the refund against any amount owed by ratepayers because of the March 18, 2021 relate-back date in this proceeding with the remainder refunded over a six month period with carrying charges at the Commission allowed weighted average cost of capital allowed.

The Tax Cuts and Jobs Act of 2017 (TCJA) reduced the corporate federal income tax rate from 35 % to 21 % effective January 1, 2018.<sup>156</sup> This reduction, and the associated revaluation of the ADFIT balances previously recorded at 35 percent decreased down to the new 21 percent tax

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<sup>154</sup> SWEPCO Ex. 1 at WP B-1.5.17 (Dolet ADIT Off-Set), the tab labeled “NOL Excess Entries.”

<sup>155</sup> *Id.*

<sup>156</sup> Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115-97, 113 Stat. 2054 (Dec. 22, 2017).

rate, results in the excess ADFIT balances that should be returned to SWEPCO's ratepayers.<sup>157</sup> The Commission determined in Docket No. 46449 that the regulatory treatment of excess deferred taxes resulting from the reduction in the federal tax rate would be addressed in SWEPCO's next base rate case.<sup>158</sup> This proceeding is SWEPCO's next base rate base after Docket No. 46449.

The normalization provisions of the IRC provide that excess ADFIT related to differences in method and life for calculating depreciation expense for book and tax purposes is considered to be protected excess ADFIT that cannot be amortized, returned to ratepayers, more rapidly than over the remaining lives of the assets that gave rise to the deferred taxes.<sup>159</sup> SWEPCO began amortizing the protected excess ADFIT on January 1, 2018<sup>160</sup> by recording a provision for refund on its books as a regulatory liability related to the Texas jurisdictional portion of this amortization.<sup>161</sup> All other excess ADFIT is considered to be unprotected, meaning there are no limitations on the timing or manner of returning it to ratepayers.<sup>162</sup>

In rebuttal testimony, SWEPCO witness Mr. Hodgson acknowledged that protected excess ADFIT represents cash that customers have paid to the utility through rates that the utility will no longer pay to the IRS in the future and that it is the amount in excess of the utility's future tax liability.<sup>163</sup> Mr. Hodgson further states that "where the utility has collected such taxes from customers in rates and it no longer required to pay the IRS because of the lower tax rate, it is reasonable for such excess to be refunded and returned to customers."<sup>164</sup> Further, Mr. Hodgson states that he disagrees with Staff's proposal to exclude excess ADFIT related to the stand-alone return NOLC by implying that ratepayers have only paid the amount of excess ADFIT net of the NOLC ADFIT:

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<sup>157</sup> Staff Ex. 3 at 42:17-19.

<sup>158</sup> Docket No. 46449, Order on Rehearing, Ordering Paragraph No. 10.

<sup>159</sup> Staff Ex. 3 at 43:1-6.

<sup>160</sup> SWEPCO Ex. 17 at 24:16-17.

<sup>161</sup> SWEPCO Ex. 6 at 49:4-5.

<sup>162</sup> Staff. Ex. 3 at 43:6-8.

<sup>163</sup> SWEPCO Ex. 45 at 20:22 – 21:4.

<sup>164</sup> *Id.* at 21:4-6.



Staff states that the excess ADFIT is the balance “that should be returned to SWEPCO’s customers.” The key word there is “returned.” The inclusion of the excess ADFIT associated with the NOL carryforward ensures that the Company returns only the amount of cash that it collected from customers through rates for its deferred taxes. Staff’s recommendation would result in the Company not only returning the cash it received from customers, but providing amount beyond what customers ever paid. The premise behind excess ADFIT is that there is a dollar-for-dollar return of cash that was over collected as a result of a rate change.<sup>165</sup>

Mr. Hodgson’s numerical examples and the related discussions at pages 22 through 24 imply that ratepayers only pay the difference between book and tax depreciation that reduces taxable income to zero and not the full difference between book and tax depreciation because of the net operating loss.<sup>166</sup>

As Staff witness Ms. Stark testified, the total of the current and deferred taxes are included in cost of service and the accumulation of the deferred taxes that would be owed in future years is the ADFIT balance.<sup>167</sup> Additionally, SWEPCO’s Schedule G-7.6 confirms that there is no reduction to the current and deferred taxes included in cost of service for a federal tax net operating loss.<sup>168</sup> Therefore, the Commission’s tax expense calculation provides for the inclusion of the full difference between accelerated and regulatory depreciation in rates without regard for any net operating loss consistent with PURA § 36.059 and 16 TAC § 25.231(b)(1)(D). Ms. Stark further testified that ADFIT is often referred to as an interest-free loan from the government because customers have paid for the deferred taxes and the utility has the opportunity to use that money in the interim before they become due in the future.<sup>169</sup> This means that ratepayers paid the full \$3,850 in tax expense in cost of service in Mr. Hodgson’s numerical example at the top of page 23 of his rebuttal testimony, not the \$3,500 that he states that SWEPCO has collected in rates.<sup>170</sup> Mr. Hodgson is confusing the reduction to the ADFIT balance in rate base, and therefore the reduction to the amount of cost-free capital available to the SWEPCO, by the net operating loss carryforward

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<sup>165</sup> *Id.* at 21:7-19.

<sup>166</sup> *Id.* at 22-24.

<sup>167</sup> Tr. at 390:6-11 (Stark Cross) (May 20, 2021).

<sup>168</sup> SWEPCO Ex. 1 at Schedule G-7.6.

<sup>169</sup> Tr. at 390:12-20 (Stark Cross) (May 20, 2021).

<sup>170</sup> SWEPCO Ex. 45 at 12: Table at top of page through 8.

with the actual amount of deferred taxes that ratepayers are required to pay in the federal income tax expense component of rates, as described above in Section II.C.1. The fact that SWEPCO has a net operating loss and has not been able to use the full difference between ratemaking and tax depreciation to offset taxable income is a function of the federal tax code.<sup>171</sup> This does not change the fact that ratepayers have paid the full amount of the excess ADFIT as described above in Section II.C.1. and should be refunded the full amount without regard to any stand-alone net operating loss. As recommended by Staff, SWEPCO's proposed adjustments to reduce the protected excess ADFIT amortization owed to ratepayers by its proposed adjustments related to a stand-alone NOLC should be rejected.<sup>172</sup>

As noted in the testimony of Ms. Stark, Staff recommends that the ALJs reject SWEPCO's proposal to offset its remaining balance of the Dolet Hills plant with the excess ADFIT owed to ratepayers resulting from the TCJA. Instead, Staff recommends that SWEPCO refund the total amount of the excess ADFIT to ratepayers by first crediting the refund against any amount owed by ratepayers because of the March 18, 2021 relate-back date in this proceeding. The remaining excess should be refunded over a six month period with carrying charges at the Commission allowed weighted average cost of capital.<sup>173</sup>

***SWEPCO's proposed pro forma adjustment of \$4,664,032 to protected excess ADFIT amortization in the federal income tax calculation in cost of service***

Staff urges the ALJs to reject SWEPCO's request to reduce the annual amortization of excess deferred taxes by its stand-alone NOLC in the tax expense calculation.

As previously explained, the normalization rules prevent the return of the protected excess ADFIT to ratepayers more rapidly than over the remaining lives of the assets that gave rise to the excess ADFIT.<sup>174</sup> The remaining balance of excess ADFIT will be amortized through the income tax expense calculation in cost of service over the course of these remaining lives.<sup>175</sup> Mr. Hodgson

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<sup>171</sup> 26 U.S. Code § 172.

<sup>172</sup> Staff. Ex. 3 at 44:4-19.

<sup>173</sup> *Id.* at 46:16 – 47:2.

<sup>174</sup> *Id.* at 45:10-12.

<sup>175</sup> *Id.* at 45:12-13.

makes the same incorrect claim with respect to the amortization of excess ADFIT included in SWEPCO's federal income tax expense in cost of service as he did with the previously amortized balance as described above in Section II.C.2. Mr. Hodgson's claim was that the adjustment for the stand-alone NOLC is required to ensure that SWEPCO returns the amount of cash collected from customers through rates for its deferred taxes.<sup>176</sup> As explained above, ratepayers paid the full amount of the excess deferred taxes without regard to any net operating loss and SWEPCO's request to reduce the annual amortization of excess deferred taxes by its stand-alone NOLC in the tax expense calculation should be rejected as recommended by Staff.<sup>177</sup>

### **III. Rate of Return [PO Issues 4, 5, 8, 9]**

#### **A. Overall Rate of Return, Return on Equity, Cost of Debt [PO Issue 8]**

Staff recommends the approval of an overall rate of return of 6.62%.<sup>178</sup> To calculate this recommended overall rate of return, Staff witness Mark Filarowicz utilized a weighted-average cost-of-capital methodology composed of three steps: (1) identifying the sources of capital and estimating the cost of each in SWEPCO's capital structure; (2) recommending an appropriate capital structure for regulatory purposes; and (3) weighing the cost of each capital source by its relative proportion in the recommended capital structure.<sup>179</sup> Taking into account these factors, when combined with SWEPCO's requested capital structure and Staff's recommended cost of debt of 4.08% and cost of equity of 9.225%, results in an overall rate of return of 6.62%.<sup>180</sup>

#### **1. Return on Equity**

The appropriate ROE for SWEPCO is 9.225%.<sup>181</sup> This figure, which also reflects a 12.5 basis point reduction for improper VM practices (as described below) was calculated by using a multi-step methodology that is well-established at the Commission and often relied upon in other rate cases.<sup>182</sup> Specifically, Staff used a Single-Stage Discounted Cash Flow (DCF) methodology,

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<sup>176</sup> SWEPCO Ex. 45 at 25:17 – 26:5.

<sup>177</sup> Staff Ex. 3 at 45.

<sup>178</sup> Direct Testimony of Mark Filarowicz, Staff Ex. 1 at 9:1-2, 33:14-17.

<sup>179</sup> *Id.* at 32:14-33:9.

<sup>180</sup> *Id.* at 33:14-17, Attachment MF-1.

<sup>181</sup> *Id.* at 8:19, 30:8-13.

<sup>182</sup> *Id.* at 12:13-15.

a Multi-Stage Discounted Cash Flow (Multi-Stage DCF) methodology, a Conventional Risk Premium Estimate, and a Capital Asset Pricing Model (CAPM) applied to a proxy group of utilities comparable to SWEPCO in order to determine the appropriate return on equity.<sup>183</sup> The results of the first three methodologies were used to determine the appropriate rate of return for SWEPCO, resulting in a point estimate of 9.35%.<sup>184</sup> The CAPM analysis was used to verify the reasonableness of this rate of return.<sup>185</sup> A 12.5 basis point adjustment was then applied to the resulting ROE based on the testimony of Staff expert witness John Poole, who sponsored the adjustment as a result of the poor quality of SWEPCO's management and service.<sup>186</sup>

Mr. Filarowicz started development of his proxy group with all of the domestic electric utility companies tracked by Value Line Investment Survey (ValueLine) in its *Ratings and Report* publication.<sup>187</sup> Mr. Filarowicz then applied select screening criteria to this group of electric utilities in order to arrive at a proxy group of companies sufficiently similar to SWEPCO.<sup>188</sup> Electric utilities meeting the following criteria were excluded from his proxy group:

- Are not followed by ValueLine;
- Have a capital structure with a long-term debt proportion outside of the 40% to 60% range;
- Do not have long-term earnings growth reported by ValueLine and Zacks investment Service (Zacks), if Zacks provides an estimate of long-term growth;
- Are not covered by Standard and Poor's (S&P) and do not have an investment grade credit rating; or if outlook is negative or utility has a negative credit watch, would lose investment grade rating if downgraded one notch in credit rating;

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<sup>183</sup> *Id.* at 12:3-11, 18:6, 25:14-15.

<sup>184</sup> *Id.* at 8: 13-15, 12:3-4.

<sup>185</sup> *Id.* at 25:14-15.

<sup>186</sup> *Id.* at 8:17-18, 30:6-8.

<sup>187</sup> *Id.* at 13:3-6.

<sup>188</sup> *Id.* at 13:5-6, 13:12.

- Have recent or potential merger activity or other major capital expansion or contraction; or undergone major, recent extraordinary events that would affect overall financial condition;
- Have recent dividend cuts or omissions;
- Are otherwise considered inappropriate for being a proxy to target the cost of equity for SWEPCO.<sup>189</sup>

After these screening criteria were applied, the following companies remained in Mr. Filarowicz's proxy group: Alliant Energy, Ameren Corporation, Avista Corporation, Black Hills Corporation, Consolidated Edison, Inc., DTE Energy, Duke Energy Corporation, Edison International, Evergy, Inc., Eversource Energy, Fortis Inc., NextEra Energy, Inc., NorthWestern Corporation, OGE Energy Corporation, Otter Tail Corporation, Pinnacle West Capital Corporation, Portland General Electric Company, Public Service Enterprise Group Incorporated, WEC Energy Group, Inc., and Xcel Energy.<sup>190</sup>

***Single-Stage Discounted Cash Flow and Multi-Stage Discounted Cash Flow***

Mr. Filarowicz applied the two DCF models to his proxy group. Mr. Filarowicz's DCF models are long-term, forward-looking models that calculate the price of a stock by estimating the value of future cash flows that the stock will produce for its owners.<sup>191</sup> The underlying theory of a DCF model is that the price of a share is equal to the present value of future cash flows.<sup>192</sup> Absent the sale of a stock, dividends are the only cash flows received by investors.<sup>193</sup> The purpose of a DCF method is not to measure the rate at which SWEPCO will actually grow (which is primarily a function of economic conditions, management ability, regulatory actions, etc.), but rather the growth expectations that investors have embodied in the current price of the stock.<sup>194</sup> Because of the relationship between earnings growth and dividends growth, the growth rates used in Mr. Filarowicz's first DCF and the first state of the multi-stage DCF analyses are the projected earnings

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<sup>189</sup> *Id.* at 13:12-14:7.

<sup>190</sup> *Id.* at 14:12-15:2.

<sup>191</sup> *Id.* at 12:5-6.

<sup>192</sup> *Id.* at 12:5-6, 15:18-19.

<sup>193</sup> *Id.* at 19:1-2.

<sup>194</sup> *Id.* at 19:7-12.

growth rates for each of the proxy companies, as forecasted by ValueLine and Zacks.<sup>195</sup> Mr. Filarowicz relied on ValueLine because it is one of the nation's largest independent investment research services, in addition to being a major money management institution.<sup>196</sup> Mr. Filarowicz relied on Zacks, because it compiles consensus earnings forecasts from groups of professional security analysts.<sup>197</sup> Mr. Filarowicz's first single-stage DCF analysis uses the stock dividend growth rate over the entire 150-year period, based on analysts' estimates for the proxy group's earnings growth over the next five years.<sup>198</sup>

In Mr. Filarowicz's second DCF analysis, the Multi-Stage DCF, he used a two-stage approach. The first stage of Mr. Filarowicz's Multi-Stage DCF analysis covers five years and uses the same analysts' estimates used in the first DCF analysis.<sup>199</sup> The second stage, which covers years six through 150, is based on long-term projected growth in Gross Domestic Product, as projected by the U.S. Bureau of Economic Analysis and the Board of Governors of the Federal Reserve System.<sup>200</sup> Mr. Filarowicz utilized the 75<sup>th</sup> percentile results from both DCF analyses in light of the current low interest rate environment, the proxy group he selected, and the nature of SWEPCO's operations.<sup>201</sup> The 75<sup>th</sup> percentile results are in accordance with recent trends in authorized ROEs approved by the Commission and across the country.<sup>202</sup>

The results of Mr. Filarowicz's DCF analyses are shown in the following table:<sup>203</sup>

	<b>Range of Results</b>	<b>Midpoint of Range</b>
Single-Stage DCF	6.59–12.00%	9.38%
Multi-Stage DCF	7.26–9.99%	9.31%
Combined DCF Point Recommendation	6.59–12.00%	9.35%

<sup>195</sup> *Id.* at 19:15-18.

<sup>196</sup> *Id.* at 19:22-20:2.

<sup>197</sup> *Id.* at 20:2-3.

<sup>198</sup> *Id.* at 18:6-8.

<sup>199</sup> *Id.* at 18:9-10.

<sup>200</sup> *Id.* at 18:10-12, 20:4-9.

<sup>201</sup> *Id.* at 21:22-22:2.

<sup>202</sup> *Id.* at 22:6-7.

<sup>203</sup> *Id.* at 28:12-16, Attachment MF-9.

### ***Conventional Risk Premium Estimate***

Mr. Filarowicz's "conventional risk premium estimate" estimated the cost of SWEPCO's equity by comparing the costs of equity authorized for electric utilities across the United States to the yields of large-company corporate bonds that are rated Baa by Moody's' Mergent Bond Data.<sup>204</sup> This risk premium approach relies on the historical relationship between two indices to forecast a value for one of the indices in a period for which it is unknown by using the known value of the other index during that same period.<sup>205</sup>

In order to account for the relationship between the authorized costs of equity and the bond yields required to quantify SWEPCO's cost of equity, Mr. Filarowicz subtracted the bond yields from the historical authorized costs of equity to determine a risk premium for the riskier equity.<sup>206</sup> The data was tested for correlation by performing a regression analysis, which showed the existence of an inverse trend in the relationship between risk premiums and bond yields with high confidence.<sup>207</sup> That is, as risk premiums increase, bond yields decrease.<sup>208</sup> On average, during the 1980 to 2020 time period, risk premiums increased 0.4457% for every 1.00% that bond yields decreased.<sup>209</sup> The results of this risk premium analysis produced a cost of equity of 9.05%.<sup>210</sup>

### ***Capital Asset Pricing Model (CAPM)***

Mr. Filarowicz used a CAPM analysis as a qualitative check on the results obtained through his use the other analyses discussed in this brief.<sup>211</sup> He did not directly incorporate the results of his CAPM analysis in determining SWEPCO's cost of equity, because the CAPM yielded a cost of equity markedly lower than the lowest of the other calculated estimates.<sup>212</sup> The CAPM provides an additional indication that a lower cost of equity is consistent with prevailing market

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<sup>204</sup> *Id.* at 24:7-10.

<sup>205</sup> *Id.* at 12:8-11.

<sup>206</sup> *Id.* at 24:15-16.

<sup>207</sup> *Id.* at 24:19-22.

<sup>208</sup> *Id.* at 24:22.

<sup>209</sup> *Id.* at 24:22-25:1-2.

<sup>210</sup> *Id.* at 25:7-8, 28:15.

<sup>211</sup> *Id.* at 25:14-15.

<sup>212</sup> *Id.* at 25:12-13.

conditions.<sup>213</sup> Specifically, the model accurately reflects the effects of the current continued low-interest-rate environment.<sup>214</sup>

The CAPM is one of the cornerstones of financial theory.<sup>215</sup> The model describes the relationship between the risk of an asset and its expected return, and assumes that investors will not hold a risky asset unless they are adequately compensated for the risk.<sup>216</sup> The risk of an asset is represented by its *beta*, which indicates the sensitivity of an individual security's return to changes in the returns of the overall market. The higher the beta, the greater the risk of an asset; relative to the risk of the overall market.<sup>217</sup> The “adequate compensation” assumed by the model is the market risk premium in excess of the equity returns offered by a risk-free investment in a U.S. Treasury security.<sup>218</sup> Additionally, CAPM analysis takes into account the volatility relative to the overall market of the equities being analyzed.<sup>219</sup> The beta-adjusted risk premium is added to the rate of return offered by risk-free investments to determine the overall required rate of return for a security.<sup>220</sup>

Mr. Filarowicz used the CAPM method to determine the costs of equity for each company in his proxy group.<sup>221</sup> In doing so, Mr. Filarowicz used a risk-free rate of 1.78%, which was the average yield of the 20-year Treasury bond for the period from December 16, 2016, through March 15, 2021.<sup>222</sup> For the beta inputs, Mr. Filarowicz used betas published by ValueLine.<sup>223</sup> For the market risk premium, Mr. Filarowicz used a rate of 6.12%, which is the arithmetic mean return value between common stocks and long-term government bonds as published in the 2018

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<sup>213</sup> *Id.* at 26:5-7.

<sup>214</sup> *Id.* at 26:7-8.

<sup>215</sup> *Id.* at 25:17.

<sup>216</sup> *Id.* at 25:17-20.

<sup>217</sup> *Id.* at 25:20-26:1.

<sup>218</sup> *Id.* at 26:16-18.

<sup>219</sup> *Id.* at 26:16-18.

<sup>220</sup> *Id.* at 26:20-21.

<sup>221</sup> *Id.* at 26:4-5.

<sup>222</sup> *Id.* at 27:3-5.

<sup>223</sup> *Id.* at 27:11.



*Valuation Handbook — U.S. Guide to Cost of Capital.*<sup>224</sup> By applying the CAPM analysis to his proxy group, Mr. Filarowicz calculated a cost of equity for SWEPCO of 7.26%.<sup>225</sup>

***Summary of Staff's Cost-of-Equity Analysis***

The results of each method utilized by Mr. Filarowicz regarding SWEPCO's cost-of-equity are as follows:<sup>226</sup>

<b><u>Methodology</u></b>	<b><u>Point Estimate</u></b>	<b><u>Range</u></b>
Single-Stage DCF Analyses	9.38%	6.59 – 12.00%
Multi-Stage DCF Analyses	9.31%	7.26 – 9.99%
Conventional Risk premium	9.05%	N/A
<b>Unadjusted ROE Estimate</b>	<b>9.35% (excluding CAPM)</b>	<b>9.05 – 9.35%</b>

***Outage Adjustment and Final Recommended ROE for SWEPCO***

In his direct testimony, Staff witness John Poole supports a downward adjustment of SWEPCO's ROE under PURA § 36.052 because of the poor quality of SWEPCO's management and service as evidenced by a cascading outage on SWEPCO's system.<sup>227</sup> A major outage on SWEPCO's system occurred on August 18, 2019 and August 19, 2019, resulting in multiple, cascading interruptions on SWEPCO's transmission grid and affecting electric cooperatives directly connected to SWEPCO's transmission system (Outage).<sup>228</sup> Vegetation contact with SWEPCO transmission lines initially caused the Outage, and resulted in a cost of \$1,129,412.82 for SWEPCO to perform additional VM and transmission line, substation, and protection work.<sup>229</sup>

The Outage is indicative of SWEPCO's failure to adequately perform the necessary VM and maintain its transmission system so as to avoid unnecessary service interruptions.<sup>230</sup> In response to Commission Requests for Information sent following the Outage, SWEPCO produced photographs showing significantly developed vegetation, including mature trees reaching

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<sup>224</sup> *Id.* at 27:18-21

<sup>225</sup> *Id.* at 28:7.

<sup>226</sup> *Id.* at 28:12-16, Attachment MF-9.

<sup>227</sup> Staff Ex. 1 at 29:14-19; Direct Testimony of John Poole, Staff Ex. 5 at 11:1-17.

<sup>228</sup> *Id.* at 6:2-6.

<sup>229</sup> *Id.* at 6:13-15.

<sup>230</sup> *Id.* at 10:3-6.

transmission lines involved in the Outage.<sup>231</sup> Furthermore, multiple transmission lines in SWEPCO's transmission system had been in service for 50 or more years, with some lines having been in service since the 1930s and 40s.<sup>232</sup> System average interruption duration index (SAIDI) and system average interruption frequency index (SAIFI) information submitted by SWEPCO illustrates that reliability did not appreciably increase following the in-service dates of certain rebuilt transmission lines.<sup>233</sup>

Mr. Poole quantifies this adjustment in terms of a decrease to SWEPCO's return in the amount of \$1,130,000.<sup>234</sup>

Utilizing Staff's recommended rate base of \$1,838,514,708 and SWEPCO's requested capital structure including 49.37% equity, Mr. Filarowicz calculates Mr. Poole's downward adjustment as an approximate 12.5 basis point reduction to SWEPCO's ROE.<sup>235</sup> Following application of this 12.5 basis point reduction, Mr. Filarowicz recommends a final total ROE for SWEPCO of 9.225%, as reflected in the table below:<sup>236</sup>

<b><u>Recommended Return on Equity</u></b>	<b><u>Percent</u></b>
ROE Point Estimate (Filarowicz Testimony)	9.350%
ROE Operations Adjustment (Poole Testimony)	(0.125%)
<b>Total Staff Recommended ROE</b>	<b>9.225%</b>

The calculation of the 12.5 basis-point adjustment reflects Staff's recommended rate base specified above; should the Commission adopt a different rate base, the quantification of the adjustment could differ.<sup>237</sup>

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<sup>231</sup> *Id.* at 6:15-18.

<sup>232</sup> *Id.* at 10:6-9.

<sup>233</sup> *Id.* at 10:10-15.

<sup>234</sup> *Id.* at 11:7.

<sup>235</sup> Staff Ex. 1 at 29:22-30:2.

<sup>236</sup> *Id.* at 30:10-13.

<sup>237</sup> *Id.* at 30:17-19.

## **Other Considerations for ROE**

### ***Size Premium***

SWEPCO's requested size premium of 20 basis points should not be added to SWEPCO's ROE in this docket.<sup>238</sup> There is no consensus among financial analysts regarding the quantification of size premiums in equity investing, and several academic authors have concluded that the size premium itself does not exist for utilities.<sup>239</sup> Additionally, a size premium is not justified in light of SWEPCO witness Mr. Dylan D'Ascendis's recommended ROE which is far higher than the average nationwide authorized ROE of 9.44%.<sup>240</sup>

### ***Creditworthiness Premium***

The Commission should also not adopt SWEPCO's proposed credit-risk premium addition of 27 basis points to its proposed ROE.<sup>241</sup> SWEPCO's current credit rating of A- from S&P is better than the proxy group's average credit rating of BBB+.<sup>242</sup> Mr. D'Ascendis did not factor in the S&P rating to his request to add a credit risk premium.<sup>243</sup> Because of the incommensurately high range for ROE recommended by Mr. D'Ascendis, as well as the general principle that a utility is responsible for managing its own creditworthiness, the Commission should not reward SWEPCO with a higher ROE based on its credit rating.<sup>244</sup>

It is the responsibility of SWEPCO's management to conduct its operations in a manner to maintain its credit rating and enhance its overall creditworthiness.<sup>245</sup> It is not the Commission's role to serve as guarantor of SWEPCO's creditworthiness.<sup>246</sup> Therefore, the Commission should reject SWEPCO's request for a credit risk premium in this docket.

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<sup>238</sup> *Id.* at 34:3.

<sup>239</sup> *Id.* at 34:3-6.

<sup>240</sup> *Id.* at 35:9-12.

<sup>241</sup> *Id.* at 35:15-16.

<sup>242</sup> *Id.* at 36:3-6.

<sup>243</sup> *Id.* at 36:6-7.

<sup>244</sup> *Id.* at 36:8-13.

<sup>245</sup> *Id.* at 36:16-20.

<sup>246</sup> *Id.* at 36:19-20.

### ***Independent Consultant***

This year's winter storm that resulted in extended outages in Texas highlights that reliability is paramount. To ensure that another large transmission outage on the scale of the August 18, 2021 through August 19, 2019 Outage does not occur, the Commission should adopt Staff witness Poole's recommendation to order SWEPCO to hire an independent contractor to promptly conduct a comprehensive review of SWEPCO's transmission system and make recommendations regarding SWEPCO's VM practices, facilities replacement, and transmission system protection.<sup>247</sup> Staff further recommends that the Commission open a compliance docket and require SWEPCO to file reports regarding its hiring and use of the independent consultant. Staff recommends SWEPCO provide information including the request for proposal to perform the related work, a notification of the independent consultant selection, a timeline for the consultant's work, as well as the consultant's reports and recommendations.<sup>248</sup>

Requiring SWEPCO to contract with an independent consultant to review its transmission system is in accordance with Commission precedent. The Commission previously ordered in Docket Nos. 16705<sup>249</sup> and 18249<sup>250</sup> that an electric utility contract with an independent consultant due to the utility's poor reliability and management.

### ***ROE Summary***

The Commission should adopt a final ROE of 9.225%, based on Mr. Filarowicz's recommended point ROE of 9.35% combined with a 12.5 basis point adjustment, as recommended by Mr. Poole. Staff further recommends SWEPCO be required to contract with an independent contractor to review its transmission system.

## **2. Cost of Debt**

Staff recommends adoption of Staff's proposal to set SWEPCO's cost of debt at 4.08%. In its application, SWEPCO's proposes a cost of debt of 4.18%.<sup>251</sup> Mr. Filarowicz recommends

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<sup>247</sup> Staff Ex. 5 at 11:14-17, 12:12-15.

<sup>248</sup> Staff Ex. 5 at 12:15-20.

<sup>249</sup> *Application of Entergy Texas for Approval of Its Transition to Competition Plan and the Tariffs Implementing the Plan and for the Authority to Reconcile Fuel Costs to Set Revised Fuel Factors and to Recover a Surcharge for Underrecovered Fuel Costs*, Docket No. 16705, Second Order on Rehearing at 18-19. (Jul. 22, 1998).

<sup>250</sup> *Entergy Gulf States, Inc. Service Quality Issues*, Docket No. 18249, Order on Rehearing at 28-29, 37 (Apr. 22, 1998), Staff Ex. 55.

<sup>251</sup> Staff Ex. 1 at 31:3-4, Direct Testimony of Renee Hawkins, SWEPCO Ex. 9 at 3-5; Application,

adjustment of the cost of debt to reflect the removal of the annual amortization of a Series I Hedge Loss sustained by SWEPCO in February 2012.<sup>252</sup> The Series I Hedge Loss will be fully amortized in January 2022, and SWEPCO ratepayers have already paid 93% to 94% of this amortization as of the filing of Mr. Filarowicz's testimony in April 2021.<sup>253</sup> By the time new rates from this docket go into effect, there will be only approximately six months of amortization remaining. As such, it is inappropriate to set new rates based on the hedge loss. The annual amortization is not indicative of SWEPCO's current annual cost of debt.<sup>254</sup>

The removal of the annual amortization of the Series I Hedge Loss results in a 10-basis point adjustment to SWEPCO's requested cost of debt of 4.18%. Therefore, Staff's final recommendation is that the Commission set SWEPCO's cost of debt at 4.08%.<sup>255</sup>

#### **B. Capital Structure [PO Issue 7]**

SWEPCO's proposed capital structure of 49.37% common equity and 50.63% long-term debt is reasonable.<sup>256</sup>

#### **C. Financial Integrity, Including "Ring Fencing" [PO Issue 9]**

Staff recommends that the Commission issue findings of fact, conclusions of law, and ordering paragraphs requiring SWEPCO to implement the financial protections recommended by Mr. Filarowicz to financially insulate SWEPCO from its parent company, AEP Energy Inc. (AEP), and AEP's other subsidiaries to protect the financial integrity of the utility and ensure reliable service at just and reasonable rates to SWEPCO's customers. AEP, with \$81 billion of assets,<sup>257</sup> is a large corporation that includes not only SWEPCO as a subsidiary, but also several other entities, including:

- Vertically Integrated Utilities: AEP Generating Company, Appalachian Power Company, Indiana Michigan Power Company, Kingsport Power Company, Kentucky

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Schedule K-3 at 1.

<sup>252</sup> Staff Ex. 1 at 31:6-7.

<sup>253</sup> *Id.* at 31:9-11.

<sup>254</sup> *Id.* at 31:14-15.

<sup>255</sup> *Id.* at 31:17-19.

<sup>256</sup> *Id.* at 8, 32:9-11.

<sup>257</sup> *Id.* at 38:6.

Power Company, Public Service Company of Oklahoma, Southwestern Electric Power Company, and Wheeling Power Company, whose business activities consist of owning and operating assets for the generation, transmission, and distribution of electricity for sale to retail and wholesale customers;

- Transmission and Distribution Utilities: AEP Texas and Ohio Power Company (OPCo), engaged in the business of owning and operating assets for the transmission and distribution of electricity for sale to retail and wholesale customers. OPCo purchases energy and capacity at auction to serve standard service offer customers and provides transmission and distribution services for all connected load;
- AEP Transmission Holdco, engaged in the business of the development, construction and operation of transmission facilities through investments in AEP Transmission Company. These investments have FERC-approved returns on equity. AEP Transmission Holdco is also engaged in the development, construction and operation of transmission facilities through investments in AEP's transmission-only joint ventures, the investments of which have PUCT-approved or FERC-approved returns on equity;
- Generation & Marketing: AEP also has business: 1) owning competitive generation in ERCOT and the Pennsylvania – New Jersey – Maryland regional transmission organization (PJM); 2) performing marketing, risk management and retail activities in ERCOT, PJM, Southwest Power Pool (SPP), and the Midcontinent Independent System Operator (MISO); and 3) holding contracted renewable energy investments and management services.<sup>258</sup>

The effects of financial instability or weakness in one entity could affect not only AEP as the parent company, but other subsidiaries as well.<sup>259</sup> In an extreme case, an event that causes severe financial distress for AEP could lead to its bankruptcy—a situation that, absent the presence of protective measures, could impact subsidiaries like SWEPCO dramatically and drag them along

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<sup>258</sup> *Id.* at 39:15-40:15.

<sup>259</sup> *Id.* at 40:18-20.

into the bankruptcy process.<sup>260</sup>

The Commission has previously ordered institution of ring-fencing provisions in multiple dockets, including in sale-transfer-merger Docket Nos. 34077,<sup>261</sup> 45188,<sup>262</sup> 47675,<sup>263</sup> 48929,<sup>264</sup> and 50584.<sup>265</sup> <sup>266</sup> The Commission has also included ring-fencing provisions in final orders of multiple rate-related dockets, including Docket Nos. 49421,<sup>267</sup> 49494,<sup>268</sup> and 49831.<sup>269</sup> <sup>270</sup> The ring-fencing provisions contained in these final orders are identical or similar to the provisions suggested in this proceeding.<sup>271</sup>

Staff recommends that the Commission implement the ring-fencing provisions below, which will create an effective degree of insulation between SWEPCO and its parent company AEP, as well as other AEP affiliates, in the event of financial distress by non-SWEPCO entities part of the AEP organization.<sup>272</sup> To the extent SWEPCO's existing policies provide compliance with any recommended provision, Staff recommends that the Commission require SWEPCO to

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<sup>260</sup> *Id.* at 40:20-23.

<sup>261</sup> *Joint Report and Application of Oncor Electric Delivery Company and Texas Energy Future Holdings Limited Partnership Pursuant to PURA § 14.101*, Docket No. 34077, Order on Rehearing (Apr. 24, 2008).

<sup>262</sup> *Joint Report and Application of Oncor Electric Delivery Company LLC, Ovation Acquisition I, LLC, Ovation Acquisition II, LLC, and Shary Holdings, LLC for Regulatory Approvals Pursuant to PURA §§ 14.101, 37.154, 39.262(l)-(m), and 39.915*, Docket No. 45188, Order (Mar. 24, 2016).

<sup>263</sup> *Joint Report and Application of Oncor Electric Delivery Company LLC and Sempra Energy for Regulatory Approvals Pursuant to PURA §§ 14.101, 39.262, and 39.915*, Docket No. 47675, Order (Mar. 8, 2018).

<sup>264</sup> *Joint Report and Application of Oncor Electric Delivery Company LLC, Sharyland Distribution & Transmission Services, L.L.C., Sharyland Utilities, L.P., and Sempra Energy for Regulatory Approvals Under PURA §§ 14.101, 37.154, 39.262, and 39.915*, Docket 48929, Order (May 9, 2019).

<sup>265</sup> *Joint Report and Application of Wind Energy Transmission Texas, LLC; Axinfra US LP, Hotspur Holdco 1 LLC; Hotspur Holdco 2 LLC, and 730 Hotspur, LLC, for Regulatory Approvals Under PURA §§ 14.101, 39.262, and 39.915*, Docket 50584, Order (Jul. 24, 2020)

<sup>266</sup> Staff Ex. 1 at 42: 6-27.

<sup>267</sup> *Application of CenterPoint Energy Houston Electric, LLC for Authority to Change Rates*, Docket No. 49421, Order, Findings of Fact Nos. 71-87 (Mar. 9, 2020).

<sup>268</sup> *Application of AEP Texas Inc. for Authority to Change Rates*, Docket No. 49494, Order, Findings of Fact Nos. 108-121 (Apr. 6, 2020).

<sup>269</sup> *Application of Southwestern Public Service Company for Authority to Change Rates*, Docket No. 49831, Order, Findings of Fact Nos. 75-91 (Aug. 27, 2020).

<sup>270</sup> Staff Ex. 1 at 43:9-16.

<sup>271</sup> *Id.* at 43:18-19.

<sup>272</sup> *Id.* at 43:22-44:4.

commit to maintaining those policies.<sup>273</sup>

**Staff Proposed Financial Protections<sup>274</sup>**

1. SWEPCO Credit Ratings. SWEPCO will work to ensure that its credit ratings at S&P and Moody's remain at or above SWEPCO's current credit ratings.
2. Notification of Less-than-Investment-Grade Rating. SWEPCO will notify the Commission if its credit issuer rating or corporate rating as rated by either S&P or Moody's falls below investment-grade level.
3. Regulatory Return on Equity (ROE) Commitment. If SWEPCO's issuer credit rating is not maintained as investment grade by S&P or Moody's, SWEPCO will not use its below-investment-grade ratings to justify an argument in favor of a higher regulatory ROE.
4. Stand-Alone Credit Rating. SWEPCO will take the actions necessary to ensure the existence of a SWEPCO stand-alone credit rating.
5. No Cross-Default Provisions. SWEPCO's credit agreements and indentures will not contain cross-default provisions by which a default by AEP or its other affiliates would cause a default by SWEPCO.
6. No Financial Covenants or Rating-Agency Triggers Related to Another Entity. The financial covenant in SWEPCO's credit agreement will not be related to any entity other than SWEPCO. SWEPCO will not include in its debt or credit agreements any financial covenants or rating-agency triggers related to any entity other than SWEPCO.
7. No Sharing of a Credit Facility. SWEPCO will not share a credit facility with any unregulated affiliates.
8. No SWEPCO Debt Secured by Non-SWEPCO Assets. SWEPCO's debt will not be secured by non-SWEPCO assets.
9. No SWEPCO Assets Pledged for Other Entities' Debt. SWEPCO's assets will not secure the debt of AEP or its non-SWEPCO affiliates. SWEPCO's assets will not be pledged for any other entity.
10. No Credit for Affiliate Debt. SWEPCO will not hold out its credit as being available to pay the debt of any AEP affiliates.

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<sup>273</sup> *Id.* at 44:12-15.

<sup>274</sup> *Id.* at 44:16-45:37.



11. No Commingling of Assets. Except for access to the utility money pool and the use of shared assets governed by the Commission's affiliate rules, SWEPCO will not commingle its assets with those of other AEP affiliates.
12. Affiliate Asset Transfer Commitment. SWEPCO will not transfer any material assets or facilities to any affiliates, other than a transfer that is on an arm's-length basis in accordance with the Commission's affiliate standards applicable to SWEPCO, regardless of whether such affiliate standards would apply to the particular transaction.
13. No Inter-Company Lending and Borrowing Commitment. Except for any participation in an affiliate money pool, SWEPCO will not lend money to or borrow money from AEP affiliates.
14. No Debt Disproportionally Dependent on SWEPCO. Without prior approval of the Commission, neither AEP nor any affiliate of AEP (excluding SWEPCO) will incur, guaranty, or pledge assets in respect of any incremental new debt that is dependent on: (1) the revenues of SWEPCO in more than a proportionate degree than the other revenues of AEP; or (2) the stock of SWEPCO.
15. No Bankruptcy Cost Commitment. SWEPCO will not seek to recover from customers any costs incurred as a result of a bankruptcy of AEP or any of its affiliates.

As Mr. Filarowicz noted, ring-fencing protections have been proven to work.<sup>275</sup> As a particular and memorable example for Texans, ring-fencing provisions in the Commission's order in Docket No. 34077 effectively insulated Oncor Electric Delivery Company from its parent company's 2014 multi-billion-dollar bankruptcy.<sup>276</sup>

#### **IV. Expenses [PO Issues 1, 14, 24, 29, 30, 32, 33, 40, 41, 42, 44, 45, 46, 49, 72, 73, 74]**

##### **A. Transmission and Distribution O&M Expenses [PO Issue 14, 24]**

##### **1. Transmission O&M Expense [PO Issue 24]**

SWEPCO's proposed transmission test year operations and maintenance expenses of \$46,700,000<sup>277</sup> are reasonable.

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<sup>275</sup> *Id.* at 46:3.

<sup>276</sup> *Id.* at 46:3-47:4.

<sup>277</sup> Direct Testimony of Daniel Boezio, SWEPCO Ex. 11 at 14:19-20

## **2. Transmission expense and revenues under FERC-approved tariff [PO Issue 46]**

Staff addresses SWEPCO's proposal to track changes in SPP transmission charges in Section IV.A.3. below, and Staff addresses SWEPCO's proposal to exclude TCRF and DCRF revenues in its evaluation of its proposed base rate increase in Section VII.B.

## **3. Proposed Deferral of SPP Wholesale Transmission Costs [PO Issues 72, 73, 74]**

The ALJs should reject SWEPCO's proposal to track changes in SPP transmission charges from Commission—approved test year SPP transmission charges. In the direct testimony of SWEPCO witness Thomas Brice, "SWEPCO proposes that the portion of its ongoing SPP OATT charges that is above or below the net test year level approved for recovery by the Commission, be deferred into a regulatory asset or liability until they can be addressed in a future TCRF or base-rate proceeding."<sup>278</sup> SWEPCO further clarifies its proposal stating that it proposes "that the portion of its ongoing SPP charges that qualify as ATC under 16 TAC § 25.239(b)(1) that is above or below the net ATC [Approved Transmission Charges] component of the baseline TCRF revenue requirement approved in this case be deferred into a regulatory asset or liability until they can be addressed in a future TCRF or base-rate proceeding."<sup>279</sup> Net ATC charges are the difference in charges that SWEPCO assessed for its use of SPP's transmission system under 16 TAC § 25.239(b)(1) and the wholesale payments it receives for the use of its transmission system.<sup>280</sup>

Regarding its proposal, SWEPCO argues that the test year amount of net transmission charges is not representative of the charges it will experience going forward and that an increase in SPP charges billed to SWEPCO would lead to under-recovery for SWEPCO.<sup>281</sup> However, as explained by Mr. Narvaez if rates are cost based then under-recovery should not be an issue because increases in SWEPCO's load that cause SWEPCO to incur increased ATC charges should be sufficiently matched by increases in base rate recovery revenue from customers.<sup>282</sup> Furthermore, SWEPCO's proposal does not account for the fact that SWEPCO receives wholesale

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<sup>278</sup> SWEPCO Ex. 4 at 12:21-23 to 13:1-5.

<sup>279</sup> Direct Testimony of John Aaron, SWEPCO Ex. 31 at 30: 10-13.

<sup>280</sup> Staff Ex. 4 at 7:14-18.

<sup>281</sup> SWEPCO Ex. 31 at 30:4-6.

<sup>282</sup> Staff Ex. 4 at 8:8-10.

transmission revenues from other SPP customers that offset the ATCs that SWEPCO pays.<sup>283</sup> Rather, it appears that SWEPCO's proposal would only track changes in SPP transmission charges for future increases or decreases in the SPP transmission charges but would not account for future changes in wholesale transmission revenues received as compared to the amount approved by the Commission for inclusion in base rates.<sup>284</sup> Additionally, SWEPCO's request is unnecessary since the TCRF mechanism under 16 TAC § 25.239(b) "is the mechanism available to SWEPCO under Commission rules to account for changes in ATC outside of its base rate case."<sup>285</sup> This TCRF mechanism is well-established by the Commission and would allow SWEPCO to recover changes in ATC charges in the manner approved by the Commission.<sup>286</sup> Furthermore, SWEPCO's proposal is unreasonable because it could result in an over-recovery of transmission charges and both PURA § 36.209(b) and 16 TAC § 25.239 do not allow for over-recovery of transmission charges.<sup>287</sup>

Overall, SWEPCO's proposal to track and defer a portion of its ongoing SPP transmission charges should be rejected by the ALJs.

#### **5. Distribution Veg Mgmt Expense & Program Expansion [PO Issue 27]**

The ALJs should adopt Staff witness Ramaswamy's recommendations that (1) SWEPCO's request for an additional five million dollars over the test year costs should be granted; (2) that SWEPCO should be required to file periodic reports in a compliance docket related to additional VM funds approved in this rate case and report on the effect such additional spending is having on its distribution outage rates in a manner consistent with Order No. 8 in Docket No. 50052, which established two requirements for similar reports as a result of SWEPCO's last base-rate case; and (3) SWEPCO must implement a four-year trim cycle within twelve months of the filing of the final order in this proceeding.

In the instant proceeding, SWEPCO has requested a proposed total annual distribution VM spend of \$14.57 million.<sup>288</sup> This includes an increase of \$5.0 million over the test year spend of

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<sup>283</sup> *Id.* at 8:13-15.

<sup>284</sup> *Id.* at 8:16-23.

<sup>285</sup> *Id.* at 9:14-15.

<sup>286</sup> *Id.* at 9:18-19.

<sup>287</sup> Staff Ex. 4 at 10.5-16.

<sup>288</sup> Rebuttal Testimony of Drew Seidel, SWEPCO Exhibit 40 at 2:4.

\$9.57 million on VM.<sup>289</sup> SWEPCO argues that this increase will improve reliability on targeted circuits as exemplified by circuits trimmed in 2018 and 2019.<sup>290</sup> Staff agrees that SWEPCO should get a \$5.0 million increase over its test year spend on VM of \$9.57 million in light of the Commission's approval of a similar, disputed request in SWEPCO's last base-rate case.<sup>291</sup>

However, consistent with the final order in SWEPCO's last base-rate case, the Commission should open a compliance docket to detail how SWEPCO is spending the additional VM funds.<sup>292</sup> Further, SWEPCO should be required to implement a four-year trim cycle for its distribution system within 12 months of the filing of the final order in this proceeding as a long-term means of addressing the reliability problems caused by SWEPCO's inadequate VM.<sup>293</sup>

SWEPCO has shown a decrease in reliability in recent years even though they received additional VM funds in their last three base-rate cases.<sup>294</sup> Like other electric utilities, SWEPCO is subject by Commission rule to standards for System Average Interruption Frequency Index (SAIFI) and System Average Interruption Duration Index (SAIDI).<sup>295</sup> The Commission's SAIFI standard measures the average number of forced, sustained distribution interruptions customers experience during a year.<sup>296</sup> The Commission's SAIDI standard measures the average forced, sustained distribution interruption duration that a customer experiences during a year.<sup>297</sup> A larger SAIFI score indicates a more frequent number of outages the average customer experiences per year. An elevated SAIDI score indicates that the average customer experienced a long duration of outages in the year. SWEPCO's SAIDI and SAIFI scores have increased in recent years, with the SAIDI score consistently exceeding the Commission set limit, meaning that the level of reliability provided by SWEPCO to its customers has consistently been below the minimum standard

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<sup>289</sup> *Id.* at 2:5-6.

<sup>290</sup> *Id.* at 2:6-9.

<sup>291</sup> Direct Testimony of Ramya Ramaswamy, Staff Exhibit 2 at 14: 15-17.

<sup>292</sup> *Id.* at 14: 18-20.

<sup>293</sup> *Id.* at 15: 1-4.

<sup>294</sup> Direct Testimony of Drew Seidel, SWEPCO Exhibit 10 at 10-11.

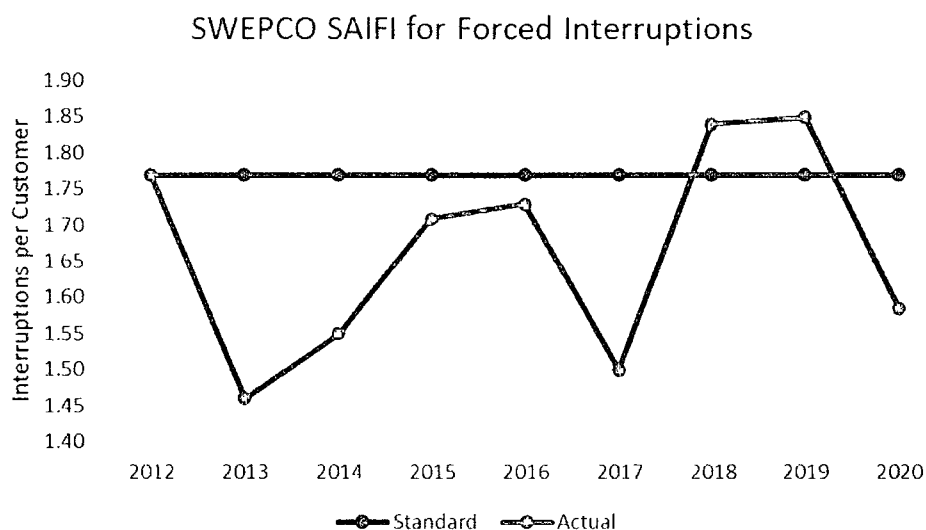
<sup>295</sup> *Id.*

<sup>296</sup> Staff Exhibit 2 at 4:20-21 to 5:1.

<sup>297</sup> *Id.* at 4:18-20.

established by the Commission. Below are the charts provided by Staff witness Ms. Ramaswamy that outline the increase in SAIFI and SAIDI values which have led to decreased reliability for SWEPCO customers.<sup>298</sup>

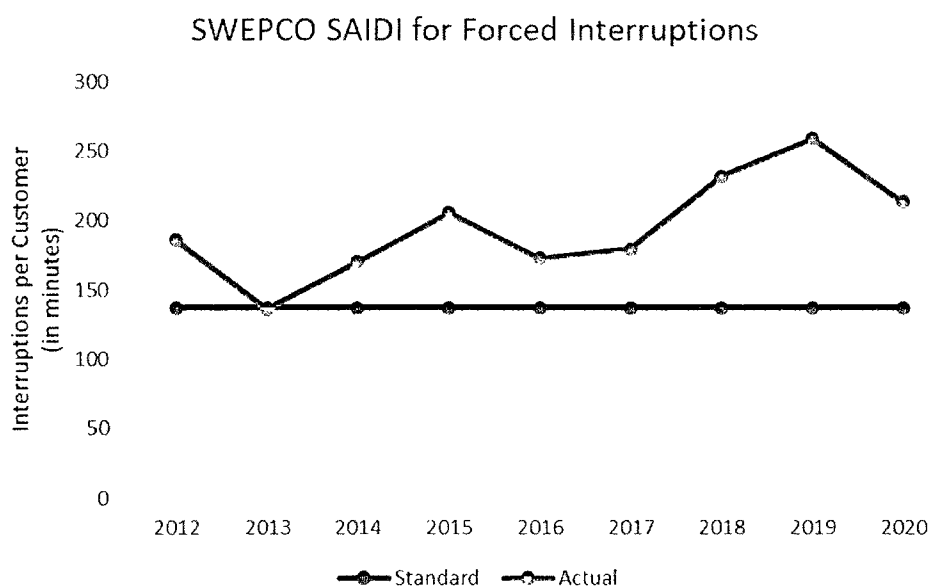
**Staff Table 1: SWEPCO SAIFI Score**



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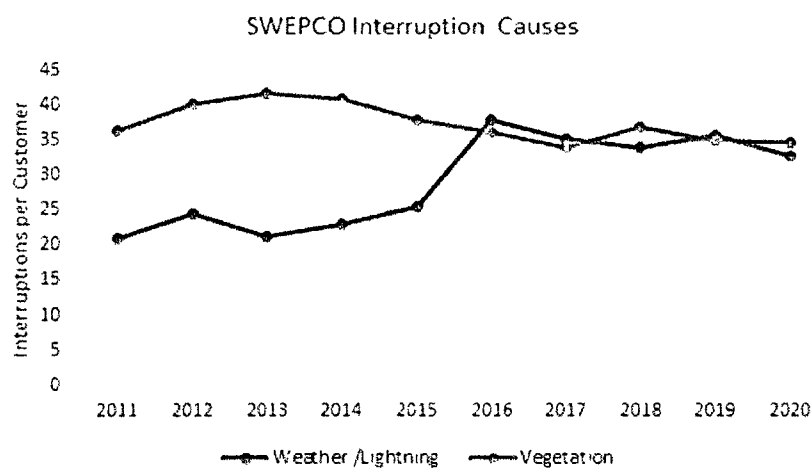
<sup>298</sup> *Id.* at 6-7.

**Staff Table 2: SWEPCO SAIDI Score**



Vegetation related interruptions for SWEPCO customers have been a major cause of outages.<sup>299</sup>

**Staff Table 3: SWEPCO Causes of Interruptions**



<sup>299</sup> SWEPCO Exhibit 10 at 11: 11-13.

In addition to the specific SAIFI and SAIDI standards that the Commission has set for SWEPCO, 16 TAC § 25.52 requires that “[e]very utility shall make all reasonable efforts to prevent interruptions of service.” SWEPCO’s own witness, Drew W. Seidel, agreed that moving to a four-year trim cycle would be a reasonable way for SWEPCO to prevent interruptions of service, which in turn would reduce SWEPCO’s violations of the Commission’s reliability standards.<sup>300</sup> However, SWEPCO has argued that it should not be required to implement the trim cycle because it would cost SWEPCO too much money.<sup>301</sup> In other words, SWEPCO argues that it should be allowed to continue to consistently fail to meet the Commission’s minimum required reliability standards due to cost. However, SWEPCO can seek recovery of an increased level of VM expense in its next rate case after it has implemented a four-year trim cycle.

SWEPCO has consistently failed to fund VM at a level necessary to meet the Commission’s mandated reliability standards. SWEPCO witness Seidel erroneously argued that Commission precedent requires SWEPCO to request additional VM money in a rate case as opposed to spending the money at the time it is needed.<sup>302</sup> SWEPCO and utilities in general routinely increase the money they spend to provide service and use such expenditures in a test year to justify increased rates, rather than failing to meet their ongoing service requirements until they obtain prefunding of needed expenditures. Although the Commission allowed increased funding of distribution VM in SWEPCO’s last rate case, that funding, like SWEPCO’s proposal for increased funding in the current rate case, was based on a specific and detailed request to spend a specific amount of money to implement a specific plan. In contrast, the amount of money necessary to implement a four-year trim cycle, as supported by SWEPCO witness Seidel, is not known and measurable and therefore does not meet the requirement for inclusion in rates under 16 TAC § 25.231. Nevertheless, SWEPCO must meet its Commission mandated reliability standards and must spend the money necessary to do so and SWEPCO can seek recovery of an increased level of VM expense in its next rate case after it has implemented a four-year trim cycle.

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<sup>300</sup> *Id.* at 20:5-9.

<sup>301</sup> *Id.* at 20:9-11.

<sup>302</sup> Tr. at 238:17-23 (Seidel Redirect) (May 19, 2021).

### **C. Labor Related Expenses**

Staff urges the ALJ to adopt Staff's positions outlined below regarding payroll expenses and incentive compensation.

#### **1. Payroll Expenses**

##### ***SWEPCO Payroll***

Staff requests an adjustment of \$544,331 be made to SWEPCO's payroll in excess of the adjustment already made by SWEPCO for payroll through October 31, 2020.

SWEPCO's requested revenue requirement includes an increase of \$2,143,713 to its test year payroll expense based on the annualization of the last pay period of the test year (March 2020) and reflecting a 3.5% salary increase to the base payroll cost.<sup>303</sup> Staff proposes an adjustment of \$544,331 in addition to SWEPCO's requested adjustment based on a more recent time period.<sup>304</sup> SWEPCO was asked in discovery to provide its most recent payroll annualized and SWEPCO provided the annualized October 31, 2020 payroll, that included SWEPCO's employees on the payroll as of that date, resulting in a total adjustment to the test-year expense of \$2,688,044.<sup>305</sup> Staff's proposed adjustment is the difference between SWEPCO's requested adjustment and this amount.

SWEPCO explains that the difference between the annualized October 31, 2020 payroll and its request is likely due to equity adjustments, line of progression promotions, and a geographic wage equalization adjustment for its craft employees.<sup>306</sup> SWEPCO also explains that additional differences are likely the result of promotions, employees qualifying for higher jobs, higher steps, and step-up pay since the test-year end.<sup>307</sup>

SWEPCO contends that Staff's proposed payroll adjustment does not follow Commission precedent in SWEPCO's last two base rate cases wherein the Commission adopted SWEPCO's test year end payroll annualization adjusted for known salary increases.<sup>308</sup> SWEPCO claims that

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<sup>303</sup> SWEPCO Ex. 6 at 21:2-7.

<sup>304</sup> Staff Ex. 3 at Attachment RS-2.

<sup>305</sup> *Id.* at Attachment RS-3.

<sup>306</sup> *Id.* at Attachment RS-4.

<sup>307</sup> *Id.* at Attachment RS-4.

<sup>308</sup> SWEPCO Ex. 36 at 32:15-18.



while employee levels may fluctuate over time, those fluctuations are not known and measurable as of the test year end.<sup>309</sup> There is no requirement in 16 TAC § 25.231 that known and measurable changes be known and measurable as of the test year end. The discussion in the next section related to AEPSC payroll illustrates the illogical results that can occur if only known and measurable changes as of the test year end are allowed by the Commission.

### ***AEPSC Payroll***

Staff recommends a payroll adjustment to AEPSC's payroll of (\$4,480,512) to reconcile the difference between SWEPCO's requested increase and this updated annualization.

SWEPCO requests an increase of \$3,804,876 to its test-year allocated AEPSC payroll expense based on an annualization of the end of test-year headcount and inclusion of a merit increase.<sup>310</sup> Similar to the SWEPCO payroll adjustment discussed above, SWEPCO provided an updated calculation based on an annualization of the October 2020 AEPSC payroll allocated to SWEPCO and compared it to the allocated test-year amount to derive an adjustment to the test-year amount of (\$675,636).<sup>311</sup> Staff's proposed adjustment of (\$4,480,512) is the difference between SWEPCO's requested increase and this updated annualization.<sup>312</sup>

SWEPCO reported that in June and July of 2020, retirement incentive packages were offered to certain employees and, while only one SWEPCO employee accepted the retirement incentive package, a total of 189 AEPSC employees accepted the package.<sup>313</sup> SWEPCO disagreed with Staff's adjustment to AEPSC payroll based on the annualization of the October 31, 2020 payroll because it claims that the impacts of the retirement offering on AEPSC billings to SWEPCO are not known and measurable, the level of services provided to SWEPCO could vary, and employee counts are not a reliable indicator.<sup>314</sup> SWEPCO further argues that Staff's proposed adjustment relies on speculation about potential future costs that is neither reliable or consistent.<sup>315</sup>

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<sup>309</sup> *Id.* at 32:19-22.

<sup>310</sup> Direct Testimony of Brian Frantz, SWEPCO Ex. 18 at 12:28-29.

<sup>311</sup> Staff Ex. 3 at Attachment RS-5.

<sup>312</sup> *Id.* at Attachment RS-6.

<sup>313</sup> *Id.* at Attachment RS-7.

<sup>314</sup> SWEPCO Ex. 36 at 34:22 – 35:3.

<sup>315</sup> *Id.* at 35:7-9.

It is known that SWEPCO offered an early retirement incentive to employees and that 189 AEPSC employees accepted that offer only due to SWEPCO's own statements. SWEPCO does not indicate why AEP offered a retirement incentive package, but companies generally offer such packages to reduce costs. The most recent measurement of the effect of that reduction in force provided by SWEPCO I 4s that its payroll costs decreased by \$675,636 from the test year level as opposed to increasing by \$3,804,876 as request by SWEPCO. If the current level of AEPSC payroll allocated to SWEPCO is more consistent with the SWEPCO's proposed level, as opposed to Staff's proposed level, SWEPCO could have provided a more recent updated AEPSC payroll annualization in its rebuttal testimony to demonstrate that, but SWEPCO did not do so. The most recent information provided by SWEPCO is that there was a decrease to the level of AEPSC allocated to SWEPCO and not an increase as proposed by SWEPCO.

## **2. Incentive Compensation**

SWEPCO has both short-term (STI) and long-term (LTI) incentive compensation plans that are explained in detail in the direct testimony of SWEPCO witness Andrew R. Carlin. While disagreeing with the Commission's precedent of excluding financial based STI and 50% of the financial based funding mechanisms related to its STI plans, SWEPCO nonetheless quantifies and excludes these costs from its requested revenue requirement for its non-union represented employees.<sup>316</sup> Additionally, SWEPCO explains that it is requesting only the target level of STI for both groups of employees (union and non-union) and not its actual test year expenses, which were higher.<sup>317</sup> SWEPCO explains that it is requesting its test-year level of LTI for the 25% that is related to restricted stock units, which are not tied to performance measures, but instead are provided to promote employee retention.<sup>318</sup> Inclusion of the restricted stock units is consistent with the Commission's order in Docket No. 46449.<sup>319</sup> SWEPCO proposes the same type of adjustments for the STI and LTI expenses allocated to SWEPCO from AEPSC.<sup>320</sup>

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<sup>316</sup> Direct Testimony of Andrew Carlin, SWEPCO Ex. 21 at 38:27-30.

<sup>317</sup> *Id.* at 39:1-5.

<sup>318</sup> *Id.* at 42:1-6.

<sup>319</sup> Docket No. 46449, Order on Rehearing, Finding of Fact No. 199.

<sup>320</sup> Staff Ex. 3 at 9:12-14.

SWEPCO noted in response to discovery that it found an error in the business unit financial based goal percentage and provided an updated calculation of the amounts.<sup>321</sup> The updated calculation provided by SWEPCO results in Ms. Stark's adjustments to incentive compensation of (\$50,709) and (\$6,131) for SWEPCO and AEPSC, respectively.<sup>322</sup> SWEPCO does not contest Ms. Stark's incentive compensation adjustments.<sup>323</sup>

Additionally, SWEPCO ascertained during discovery that its requested revenue requirement erroneously includes \$43,345 of financial based incentive compensation that was capitalized.<sup>324</sup> Ms. Stark's adjustment of (\$42,039) removes these costs net of amortization of \$1,306 from SWEPCO's requested rate base.<sup>325</sup> SWEPCO agrees with both of Ms. Stark's adjustments to remove the capitalized financial based incentive compensation from rate base.<sup>326</sup>

Staff urges the ALJs to adopt the above outlined adjustments to incentive compensation for both SWEPCO and AEPSC.

**a. Short-Term Incentive Compensation**

Staff addresses Short-Term Incentive Compensation above in Section IV.C.

**b. Long-Term Incentive Compensation**

Staff addresses Short-Term Incentive Compensation above in Section IV.C.

**D. Depreciation and Amortization Expense [PO Issue 29]**

***Depreciation***

Staff urges the ALJs to adjust SWEPCO's depreciation and amortization expense downward consistent with Staff's recommendations below.

As discussed in section II.A.1 of this brief, the Dolet Hills generating plant will be retired no later than December 31, 2021, and SWEPCO proposes an accelerated recovery of the remaining book value by using the excess ADFIT regulatory liabilities owed to ratepayers to partially offset

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<sup>321</sup> *Id.* at Attachment RS-8.

<sup>322</sup> *Id.* at Attachment RS-9 and Attachment RS-10.

<sup>323</sup> SWEPCO Ex. 36 at 29:1-8.

<sup>324</sup> Staff Ex. 3 at Attachment RS-11.

<sup>325</sup> *Id.* at 10:1-6.

<sup>326</sup> SWEPCO Ex. 36 at 26:4-7.

the net book value and then depreciating the remaining balance over a four-year period.<sup>327</sup> SWEPCO's requested revenue requirement includes depreciation expense of \$10,120,877 on its calculated residual Dolet Hills net book value after the excess ADFIT offset.<sup>328</sup> Consistent with Ms. Stark's proposed method of recovery for the retiring Dolet Hills plant (discussed in Section II.A.1), SWEPCO's requested \$10,120,877 of Dolet Hills depreciation expense should be removed from SWEPCO's requested revenue requirement.<sup>329</sup>

Ms. Stark also recommends adjustments to depreciation expense associated with her other proposed plant in service disallowances.<sup>330</sup> These include an adjustment for the depreciation expense associated with capitalized financial based incentive compensation of (\$1,306) and an adjustment of (\$464,939) related to the removal of the retired gas generating units from plant in service.<sup>331</sup> Mr. Baird stated in SWEPCO's rebuttal testimony that he does not agree with Ms. Stark's adjustments to depreciation expense because they relate to the removal of the Dolet Hills and retired gas plants from rate base, but indicated that if the Commission adopts her position, then he would not contest these depreciation expense synchronization adjustments.<sup>332</sup>

One final issue with respect to depreciation expense is SWEPCO's request to include test-year losses from disposition of utility plant of \$653,208 in its requested depreciation expense.<sup>333</sup> Because rates from this proceeding are expected to be in effect for a four-year period, Ms. Stark recommends including only one-fourth of this amount in SWEPCO's revenue requirement.<sup>334</sup> This results in an additional adjustment of (\$489,906) to depreciation expense.<sup>335</sup> Mr. Baird indicated in rebuttal that he does not contest Ms. Stark's recommendation to amortize the loss from disposition of the utility plant over four years.<sup>336</sup>

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<sup>327</sup> Staff Ex. 3 at 47:5-9.

<sup>328</sup> *Id.* at 47:9-11.

<sup>329</sup> *Id.* at 47:11-14.

<sup>330</sup> *Id.* at 47:14-16.

<sup>331</sup> *Id.* at 47:14-16.

<sup>332</sup> SWEPCO Ex. 36 at 37:7-10.

<sup>333</sup> SWEPCO Ex. 1 at WP A, Line 264.

<sup>334</sup> Staff Ex. 3 at 47:19-21.

<sup>335</sup> *Id.* at 47:19-21.

<sup>336</sup> SWEPCO Ex. 36 at 37:11-13.

Overall, Staff urges the ALJs to (1) remove the \$10,120,877 of Dolet Hills depreciation expense from its revenue requirement; (2) make an adjustment for the depreciation expense associated with capitalized financial based incentive compensation of (\$1,306) (3) make an adjustment of (\$464,939) related to the removal of the retired gas generating units from plant in service; and (4) make an adjustment of (\$489,906) to depreciation expense for test-year losses from disposition of the utility plant.

#### ***Amortization***

SWEPCO's requested revenue requirement includes an amount of amortization related to an intangible asset that was fully amortized as of the end of the test year.<sup>337</sup> Ms. Stark proposes an adjustment of (\$1,855,750) to correct this error.<sup>338</sup> Mr. Baird indicated in rebuttal that he does not contest Ms. Stark's adjustment to intangible plant amortization.<sup>339</sup>

#### **F. Affiliate Expenses [PO Issue 42]**

The ALJs should adopt Staff's adjustments outlined below regarding affiliate expenses of SWEPCO.

Ms. Stark proposes an adjustment of (\$1,164,427) to remove carrying charges associated with affiliate or shared assets.<sup>340</sup> In Docket No. 43695, the Commission disallowed such carrying charges on affiliate assets, finding that:

A component of the shared facilities charges SPS incurred from affiliates included the carrying costs associated with those facilities. Because these carrying costs are unnecessary and unreasonable, \$1,564,659 should be removed from SPS's affiliate expense. SPS should also make a corresponding decrease to FERC account 922 of \$1,187,726 in revenue SPS has received related to carrying costs. This results in a net reduction of \$376,933 (total company).<sup>341</sup>

Ms. Stark's recommendation is consistent with this Commission precedent. Ms. Stark also recommends removal of the carrying charges SWEPCO received from its affiliates in the form of

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<sup>337</sup> Staff Ex. 3 at 16:20-21.

<sup>338</sup> *Id.* at 16:21-22.

<sup>339</sup> SWEPCO Ex. 36 at 21-23.

<sup>340</sup> Staff Ex. 3 at 13:15-16.

<sup>341</sup> *Application of Southwestern Public Service Company for Authority to Change Rates*, Docket No. 43695, Order on Rehearing, Finding of Fact No. 137 (Feb. 23, 2016).

rent billings (and included in rent income) in the amount of (\$530,384).<sup>342</sup> Reducing rent income partially offsets the reduction for carrying charges paid by SWEPCO.<sup>343</sup> The net adjustment to SWEPCO's revenue requirement resulting from these adjustments to carrying charge revenues and expenses is (\$634,043).<sup>344</sup> SWEPCO does not contest these adjustments.<sup>345</sup>

#### **G. Federal Income Tax Expense [PO Issues 32, 33]**

Ms. Stark's adjustment to federal income tax expense is the result of her adjustments to SWEPCO's requested balance of invested capital combined with adjustments to the requested cost of capital (rate of return) as recommended by Mr. Filarowicz.<sup>346</sup> Changes to invested capital and rate of return impact the allowed return amount and thereby flow through in the tax calculation.<sup>347</sup> With the exception of the return and synchronized interest amounts related to the change in invested capital and rate of return and her adjustment to the amortization of protected excess ADFIT as described above, Ms. Stark's federal income tax calculation uses Tax Method One and is consistent with SWEPCO's calculation presented on Schedule G-7.8 of the Application.<sup>348</sup> Ms. Stark's federal income tax calculation is also consistent with PURA § 36.060 and 16 TAC § 25.231(b)(1)(D).<sup>349</sup> SWEPCO concurs that federal income taxes should be updated and synchronized with the final revenue requirement in this case.<sup>350</sup>

#### **H. Taxes Other Than Income Tax [PO Issue 30]**

##### **1. Ad Valorem (Property) Taxes**

The ALJs should adopt Staff's recommendation that the applicable effective ad valorem tax rate is therefore 0.961262% and that the effective rate should be applied to the final level of plant investment approved by the Commission in this proceeding.

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<sup>342</sup> Staff Ex. 3 at Attachment RS-17.

<sup>343</sup> *Id.* at 14:20-21.

<sup>344</sup> *Id.* at 14:21-22.

<sup>345</sup> SWEPCO Ex. 36 at 36:9-11.

<sup>346</sup> Staff Ex. 3 at 54:13-15.

<sup>347</sup> *Id.* at 54:15-17.

<sup>348</sup> *Id.* at 54:17-21.

<sup>349</sup> *Id.* at 54:21-22.

<sup>350</sup> SWEPCO Ex. 36 at 39:10-13.

SWEPCO states that it has reflected an increase of \$5,049,000 to ad valorem tax expense by applying an effective ad valorem tax rate to its requested plant in service balance.<sup>351</sup> SWEPCO correctly notes that ad valorem taxes recorded in a given year are based on property values at the beginning of that year (i.e., 2019 ad valorem tax expense is based on the January 1, 2019 plant values).<sup>352</sup> SWEPCO claims that its calculated effective ad valorem tax rate synchronizes ad valorem tax expense with the associated plant investment in rate base.<sup>353</sup> Staff disagrees that SWEPCO has properly synchronized ad valorem tax expense with the associated plant investment in rate base as explained below.

SWEPCO's calculation of its requested ad valorem tax expense begins with an amount of \$6,315,734,214 that it identifies as its January 1, 2019 net electric plant subject to ad valorem tax.<sup>354</sup> SWEPCO then indicates that \$63,325,856 of ad valorem taxes were paid for in the 2019 tax year.<sup>355</sup> SWEPCO divides the \$63,325,856 of 2019 ad valorem taxes paid by the \$6,315,734,214 plant balance identified by SWEPCO as the January 1, 2019 balance subject to ad valorem tax to determine its effective ad valorem tax rate of 1.00266816%.<sup>356</sup> SWEPCO applies this effective rate to its adjusted plant balance at March 31, 2020 of \$6,824,528,669<sup>357</sup> to reach a total ad valorem tax on the March 31, 2020 adjusted plant balance. The test-year capitalized amount of ad valorem tax is removed from the March 31, 2020 calculated total tax to reach SWEPCO's requested ad valorem tax expense of \$67,464,506.<sup>358</sup> Subtracting the actual test-year book ad valorem tax expense of \$62,415,506<sup>359</sup> from the requested amount results in SWEPCO's requested increase of \$5,049,000.<sup>360</sup>

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<sup>351</sup> SWEPCO Ex. 6 at 29:16-19.

<sup>352</sup> *Id.* at 29:16-22.

<sup>353</sup> *Id.* at 26:19 – 27:2.

<sup>354</sup> Staff Ex. 3 at Attachment RS-52 (WP A-3.13.1 (ad valorem), line 1).

<sup>355</sup> *Id.* at line 2.

<sup>356</sup> *Id.* at line 3

<sup>357</sup> *Id.* at line 4.

<sup>358</sup> *Id.* at line 5.

<sup>359</sup> *Id.* at line 8.

<sup>360</sup> *Id.* at line 9.

### *Ad valorem tax effective rate*

As noted above, SWEPCO has not properly synchronized its ad valorem tax expense with the associated plant investment and its calculated effective ad valorem tax rate of 1.00266816% is too high.<sup>361</sup> First, SWEPCO had \$25,841,960 related to capital leases on its books at January 1, 2019 that it did not include in the \$6,315,734,214 balance subject to ad valorem taxes for purposes of calculating its effective ad valorem tax rate.<sup>362</sup> However, the taxes paid on capital leases are included in the \$63,325,856 amount of 2019 ad valorem taxes paid by SWEPCO that is used to determine the effective rate.<sup>363</sup> Including the taxes on capital leases in the numerator (2019 taxes paid) while excluding the balance of the capital leases in the denominator (January 1, 2019 property subject to property taxes) overstates the effective ad valorem tax rate and fails to properly synchronize the plant balances with the associated ad valorem tax expense.<sup>364</sup> Correcting for this error alone reduces the effective ad valorem rate to 0.9986%:

SWEPCO's 1/1/2019 balance subject to ad valorem tax	\$6,315,734,214
Capital lease balance at 1/1/2019	<u>\$ 25,841,960</u>
Total 1/1/29 subj. to ad valorem including capital leases	\$6,341,576,174

Effective rate: \$63,325,856 taxes paid 2019 ÷ \$6,341,576,174 = 0.9986%

SWEPCO did not contest the inclusion of the capital lease balances in the calculation of the effective ad valorem tax rate and agreed with the rate calculated above.<sup>365</sup>

A second issue that results in improper synchronization between the effective ad valorem tax rate and the associated property subject to the tax relates to Texas jurisdictional differences in the balances of property subject to ad valorem tax. Two of the pro forma plant adjustments that SWEPCO included in the March 31, 2020 plant balance of \$6,824,528,669 that it applied the effective ad valorem rate are the adjustments to plant in service to account for the use of the Texas-only depreciation rates and the Texas-only AFUDC rate.<sup>366</sup> These adjustments recognize what the

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<sup>361</sup> Staff Ex. 3 at 49:4-7.

<sup>362</sup> *Id.* at 49:12-16.

<sup>363</sup> *Id.* at 50:3-4.

<sup>364</sup> *Id.* at 50:8-12.

<sup>365</sup> SWEPCO Ex. 36 at 39:6-9.

<sup>366</sup> Staff Ex. 3 at 50:18-21.



balance of the plant and accumulated depreciation accounts would be if the Texas depreciation and AFUDC rates were used in all SWEPCO jurisdictions.<sup>367</sup> When providing the January 31, 2019 balances of property included in the March 31, 2020 requested net plant balance of \$6,824,528,669, SWEPCO provided “N/A” as the January 1, 2019 balance for these proposed pro forma adjustments to net plant in service.<sup>368</sup> However, these depreciation and AFUDC differences also existed at January 1, 2019 with the balance of the Texas depreciation rate difference being \$189,282,510 and the AFUDC difference being \$56,925,902 as of that date.<sup>369</sup>

Failure to include the January 1, 2019 balance of these items in the calculation of the effective rate while applying the effective rate to the March 31, 2020 balance that includes them does not properly synchronize the effective ad valorem tax rate with the associated property subject to the tax.<sup>370</sup> This results in another mismatch between the calculated effective rate and the assets to which it is applied.<sup>371</sup> Once again, the denominator in the calculation of the effective rate is understated by the January 1, 2019 balances of these items, which has the effect of overstating the effective ad valorem tax rate.<sup>372</sup>

SWEPCO claims that by not recognizing that Texas depreciation rates have been lower over time than other states, the undepreciated value of SWEPCO’s assets are higher in Texas and that Ms. Stark’s adjustment results in SWEPCO’s other states subsidizing Texas rates.<sup>373</sup> As Ms. Stark testified, she excluded the Texas jurisdictional adjustments from the ad valorem tax calculation because SWEPCO did not include them in the January 1, 2019 plant balance used to calculate the effective ad valorem tax rate and SWEPCO should have included them if it intended to apply the effective rate to them to properly synchronize the effective rate with the assets to which it is applied.<sup>374</sup> This results in an apples to apples calculation between the determination of the effective rate with the assets to which it applies unlike SWEPCO’s approach. SWEPCO has

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<sup>367</sup> *Id.* at 50:21-23.

<sup>368</sup> *Id.* at 50:15-18.

<sup>369</sup> SWEPCO’s Response to Staff’s Seventeenth Request for Information at 17-13, Staff Ex. 12 at 17-13(b).

<sup>370</sup> Staff Ex. 3 at 51:3-6.

<sup>371</sup> *Id.* at 51:6-7.

<sup>372</sup> *Id.* at 51:7-10.

<sup>373</sup> SWEPCO Ex. 36 at 38:8-13.

<sup>374</sup> Staff Ex. 3 at 51:7-10.

identified an effective ad valorem tax rate of .00961262 (or .961262%) if the January 1, 2019 balances of the Texas jurisdictional differences are included in the determination of the effective rate.<sup>375</sup>

SWEPCO claims that including the jurisdictional adjustment in the determination of the effective rate negates the effect of the jurisdictional differences.<sup>376</sup> However, SWEPCO itself includes Texas jurisdictional differences in the calculation of its effective tax rate that serve to reduce the balance of plant subject to the tax (and therefore increase the effective rate) such as the Texas jurisdictional Turk imprudence disallowance, Texas VM write-offs, and capitalized incentive compensation, among others.<sup>377</sup> SWEPCO, as the party with the burden of proof, has provided no evidence or justification for why it is appropriate to include the Texas jurisdictional differences that increase the effective rate while arguing against including Texas jurisdictional differences that decrease the effective rate. If the ad valorem tax is to include the Texas jurisdictional plant differences, the correct effective rate to apply is the one that properly synchronizes those differences by including them in the determination of the rate. The appropriate effective ad valorem tax rate is the .961262% rate identified by SWEPCO if the Texas jurisdictional depreciation and AFUDC differences are included in the determination of ad valorem tax expense.

***Plant included in ad valorem tax calculation.***

SWEPCO agreed in its rebuttal case that the Commission should synchronize the final amount of ad valorem taxes with the final level of investment, including Texas jurisdictional adjustments.<sup>378</sup> Staff recommends reductions to net plant in service of (\$42,039) for capitalized financial based incentive compensation, (\$39,073,484) to remove SWEPCO's adjusted remaining book balance of Dolet Hills (after its proposed excess ADFIT offset), and (\$13,240,470) associated with the retired gas generating units, and therefore recommends these items should be removed from the ad valorem tax expense calculation.<sup>379</sup>

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<sup>375</sup> Staff Ex. 12.

<sup>376</sup> *Id.* at Staff 17-13(e).

<sup>377</sup> SWEPCO Ex. 1 at WP A-3.13.1 (ad valorem).

<sup>378</sup> SWEPCO Ex. 36 at 39:6-9.

<sup>379</sup> Staff Ex. 3 at 52:10-15.

SWEPCO also includes the \$44,719,222 net balance of its operating leases in the March 31, 2020 requested plant balance to which its effective ad valorem tax rate is applied. SWEPCO noted in response to discovery related to its accounting for lease expenses that “[t]hese leases require payments of non-lease components, including related property taxes, operating and maintenance costs. As of the adoption date of ASU 2016-02, management elected not to separate non-lease components from associated lease components . . . .”<sup>380</sup> SWEPCO’s test-year-end trial balance at Schedule A-4 confirms that only ad valorem taxes on capital leases are included in its test-year ad valorem tax expense.<sup>381</sup> SWEPCO does not separately account for the property taxes on its operating leases in its property tax expense account. Additionally, SWEPCO confirms that it does not separate non-lease components like property taxes from the associated lease components. Therefore, including these leases in the calculation of property tax expense would have the effect of double-counting this expense in SWEPCO’s cost of service.<sup>382</sup> SWEPCO did not contest exclusion of operating leases from ad valorem tax in its rebuttal testimony.

Staff urges the ALJs that it is appropriate to include the January 1, 2019 capital lease balances as well as the Texas jurisdictional depreciation and AFUDC differences in the calculation of the effective ad valorem tax rate. The applicable effective ad valorem tax rate is therefore 0.961262%. This effective rate should be applied to the final level of plant investment approved by the Commission in this proceeding. Consistent with Staff’s recommendation, this should be SWEPCO’s requested March 31, 2020 net plant balance excluding net operating lease balances, capitalized financial based incentive compensation, the balance of Dolet Hills included in SWEPCO’s requested rate base, and the retired gas generating units.

## **2. Payroll Taxes**

The ALJs should adopt Ms. Stark’s recommended adjustments to SWEPCO’s requested payroll and incentive compensation expenses and find that it is appropriate to reflect an associated adjustment to payroll tax expense of (\$258,162).<sup>383</sup> SWEPCO witness Mr. Baird recognized that

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<sup>380</sup> *Id.* at Attachment RS-55.

<sup>381</sup> SWEPCO Ex. 1 at Schedule A-4.

<sup>382</sup> Staff Ex. 3 at 52:3-7.

<sup>383</sup> *Id.* at 53:14-17.

this was done to synchronize payroll tax expense with the recommended payroll expense.<sup>384</sup> However, SWEPCO witness Mr. Carlin disagreed that the attendant payroll taxes related to disallowed incentive compensation should be removed.<sup>385</sup> Mr. Carlin argued that the reason financial based incentive compensation is removed is because it benefits shareholders rather than customers and that no party challenged the reasonableness of SWEPCO's costs from a cost or market-competitive compensation perspective.<sup>386</sup> Mr. Carlin stated that SWEPCO's incentive compensation is therefore a reasonable cost of doing business and, if SWEPCO were to reduce or eliminate incentive compensation, it would need to offset it with additional base pay, so SWEPCO would still incur these payroll taxes.<sup>387</sup>

The Commission has previously ruled that removing the corresponding flow through reductions associated with the elimination of incentive plan costs results in an allowable expense for the incentive plan that is reasonable and necessary for the provision of service.<sup>388</sup> The Commission has been removing financial based incentive costs and the related attendant impacts from payroll taxes from cost of service since at least 2005<sup>389</sup> and SWEPCO has not chosen to eliminate such compensation or replace it with additional base pay since that time. What SWEPCO might do regarding incentive and base pay and how that could impact payroll taxes is merely speculation. Overall, there should be an adjustment of (\$258,162) to SWEPCO's requested payroll and incentive compensation expenses to reflect an associated adjustment to SWEPCO's payroll tax expense.

### **3. Gross Margin Tax**

The ALJs should find that revenue-related taxes should be updated and synchronized with the final revenue requirement in this case

There are several taxes that are assessed on the revenues of a utility. The PUC assessment, Texas gross receipts tax, municipal gross receipts tax, and the Texas Margins tax are all examples

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<sup>384</sup> SWEPCO Ex. 36 at 34:10-14.

<sup>385</sup> SWEPCO Ex. 46 at 17:1.

<sup>386</sup> *Id.* at 17:1-5.

<sup>387</sup> *Id.* at 17:5-15.

<sup>388</sup> Docket No. 46449, Order on Rehearing, Finding of Fact No. 198.

<sup>389</sup> *Application of AEP Texas Central Company for Authority to Change Rates*, Docket No. 28840, Final Order (Aug. 15, 2005).

of taxes assessed on utility revenues.<sup>390</sup> As these taxes are based on SWEPCO's level of revenues, it follows that any adjustments made to SWEPCO's requested revenue requirement would result in attendant impacts to these revenue related taxes.<sup>391</sup> SWEPCO developed effective tax factors for each of these taxes based on its test year level of revenues and the associated tax expense for its use on Schedule A to determine its revenue deficiency.<sup>392</sup> Ms. Stark applies these factors to Staff's recommended revenue requirement reduction, resulting in adjustments to SWEPCO's requested revenue related taxes.<sup>393</sup> SWEPCO concurs that revenue-related taxes should be updated and synchronized with the final revenue requirement in this case.<sup>394</sup>

#### **V. Billing Determinants [PO Issue 4, 5, 6, 54]**

SWEPCO proposes adjusting billing determinants to account for estimated customer migration issues from the General Services Tariff to the Lighting and Power Tariff.<sup>395</sup> The ALJs should reject SWEPCO's adjustment to billing determinants in this manner. While SWEPCO argues that such adjustments to billing determinants is allowed by the rate filing package instructions,<sup>396</sup> adjusting billing determinants to account for customer migration violates 16 TAC § 25.234(b), which requires that rates be "determined using revenues, billing and usage data for a historical test year adjusted for known and measurable changes. . . ."<sup>397</sup> rather than using estimates for unknown and speculative future customer migration.<sup>398</sup> The fact that the rate filing package allows a utility to propose the use of estimated billing determinants in certain situations does not mean that the requirement under 16 TAC § 25.234(b) to use historical test year billing determinants when they are available is obviated. SWEPCO's proposed use of estimates to adjust billing determinants based on speculative customer migration should be rejected.

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<sup>390</sup> Staff Ex. 3 at 53:21-23.

<sup>391</sup> *Id.* at 53:23 – 54:2.

<sup>392</sup> *Id.* at 54:2-4.

<sup>393</sup> *Id.* at 54:4-6.

<sup>394</sup> SWEPCO Ex. 36 at 39:10-13.

<sup>395</sup> Direct Testimony of Jennifer Jackson, SWEPCO Ex. 32 at 19:7-13.

<sup>396</sup> Rebuttal Testimony of Jennifer Jackson, SWEPCO Ex. 55 at 17:8-11.

<sup>397</sup> Staff Ex. 4 at 28:1-9; 16 TAC § 25.234(b).

<sup>398</sup> *Id.* at 28:8-9.

Staff further addresses rate migration and the General Services Tariff in Section VII.B.

**VI. Functionalization and Cost Allocation [PO Issues 4, 5, 52, 53, 55, 56, 57, 58]**

**A. Jurisdictional Allocation [PO Issues 55, 57]**

The ALJs should adopt Staff's Jurisdictional Cost of Service Summary as shown in the testimony of Staff witness Adrian Narvaez.<sup>399</sup>

**B. Class Allocation [PO Issues 53, 58]**

Staff supports the class allocation shown in its Class-Functional Cost of Service Summary attached to the direct testimony of Staff witness Adrian Narvaez.<sup>400</sup>

**VII. Revenue Distribution and Rate Design [PO Issues 4, 5, 47, 48, 52, 59, 60, 61, 62, 75, 76, 77, 78, 79]**

Revenue distribution establishes the revenue requirement for each class.<sup>401</sup> PURA requires that rates be just and reasonable; that they not be unreasonably preferential, prejudicial, or discriminatory, but rather that they be equitable and consistent in application to each class of customer. The Commission's rules reflect these requirements by mandating that rates be based on cost. Therefore, ideally, the Commission approved class cost-of-service study (CCOSS) results should dictate the change to each class's revenue requirement.<sup>402</sup> SWEPCO's proposed revenue distribution does not comply with PURA or the Commission rule in this regard.

As discussed below, the ALJs should reject SWEPCO's gradualism proposal and instead adopt Staff's multi-year phased in revenue distribution proposal as it achieves a gradual movement towards cost-based rates for each class in SWEPCO's CCOSS.<sup>403</sup> Staff's multi-year phased in revenue distribution proposal uses the methodology approved by the Commission in SWEPCO's last base rate case, Docket No. 46449, to set class revenue targets for each class during each phase.<sup>404</sup> Ultimately, Staff's proposal for revenue distribution "recognizes that full movement to

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<sup>399</sup> *Id.* at bates 33, Attachment AN-2.

<sup>400</sup> *Id.* at bates 34, Attachment AN-3.

<sup>401</sup> *Id.* at 11:12.

<sup>402</sup> Staff Ex. 4 at 11:13; SWEPCO Ex. 32 at 10:10-11.

<sup>403</sup> Staff Ex. 4 at 34 – 35, Attachment AN-4.

<sup>404</sup> *Id.* at 23:18-20.

cost in one step would be harsh to particular customer classes, yet would recognize the results of the Commission determinations as regards the CCOSS, and gradually move rates to the cost-based level required by 16 TAC § 25.234.”<sup>405</sup>

Furthermore, the high-degree of customer migration permitted under SWEPCO’s tariff inequitably allows some customers to avoid cost-based rates by allowing them to opportunistically switch between rate classes, most of which do not reflect cost-based rates.<sup>406</sup> SWEPCO also uses the potential for customer migration as an excuse to avoid complying with the Commission’s requirements for cost-based rates.<sup>407</sup> The ALJs should therefore additionally adopt Staff’s recommendation that SWEPCO be required to revise its tariff in the next major rate proceeding to eliminate the potential for optional customer migration between base rate classes or between any other customer classification.<sup>408</sup> Finally, the ALJs should reject SWEPCO’s proposal to remove the current General Service rate schedule provision that restricts availability to customers with a maximum demand that does not exceed 50kW.<sup>409</sup>

While SWEPCO’s revenue distribution as modified in its rebuttal testimony does move classes closer to cost based rates; however, it does not accomplish the Commission’s stated goal of having “all classes pay their cost and that no class pay more or less than its cost.”<sup>410</sup> Additionally, SWEPCO’s proposal still allows for migration, which “undermines the Commission’s ability to establish just and reasonable rates.”<sup>411</sup>

Overall, Staff supports the revenue distribution proposal as shown in the direct testimony of Adrian Narvaez.<sup>412</sup>

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<sup>405</sup> *Id.* at 26:5-8.

<sup>406</sup> *Id.* at 28:20, 29:1-2.

<sup>407</sup> *Id.* at 28:12-15.

<sup>408</sup> *Id.* at 29:6-11.

<sup>409</sup> *Id.* at 29:4-7.

<sup>410</sup> Docket No. 46449, Proposal for Decision at 356 (Sept. 21, 2017).

<sup>411</sup> Staff Ex. 4 at 28:20 to 29:1-2.

<sup>412</sup> *Id.* at 41-44, Attachment AN-6.

### **A. Rate Moderation / Gradualism [PO Issue 52]**

SWEPCO's rate moderation proposal should be rejected because SWEPCO violates recent Commission precedent by excluding DCRF and TCRF revenues when evaluating the magnitude of SWEPCO's proposed base rate increases, because SWEPCO capped rate increases for CCOSS classes were capped at levels below the level of rate caps recently approved by the Commission, and because the proposed rate moderation does not achieve a significant movement towards cost for several classes.<sup>413</sup>

Under SWEPCO's revenue distribution proposal, DCRF and TCRF revenues are not accounted for when evaluating the magnitude of SWEPCO's proposed base rate increases. This approach overstates the magnitude of rate increases and interferes with a proper evaluation of the potential for "rate shock" and the need for imposing rate moderation, or gradualism. In this proceeding, the currently existing TCRF and DCRF revenues will be set to zero, and the related costs will be effectively "rolled into" base rates.<sup>414</sup> As Mr. Narvaez explains, TCRF and DCRF mechanisms recover base-related transmission and distribution costs incurred subsequent to the test year in SWEPCO's last base rate case.<sup>415</sup> Therefore, "the proper evaluation of SWEPCO's proposed rate increase should compare the proposed base rate revenues to present base rate test year revenues including TCRF and DCRF revenues because such an approach reflects the total base-rate-related revenues that customers are paying."<sup>416</sup> Furthermore, in SWEPCO's last base rate case, the Commission determined that classes' present revenues should be evaluated inclusive of existing TCRF and DCRF revenues to determine if a rate increase warrants gradual movement to cost.<sup>417</sup> As Mr. Narvaez explains, "focusing solely on the increase in certain rates while ignoring the fact that the TCRF rate and DCRF rate will be going down to zero would give a misleading sense of whether the rate changes at issues are 'out of proportion or harsh.'"<sup>418</sup> Furthermore, since SWEPCO excluded DCRF and TCRF revenues when evaluating the magnitude of its proposed

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<sup>413</sup> *Id.* at 15:9-16, 23:2-7.

<sup>414</sup> SWEPCO Ex. 32 at 8:16-17, 12:6-7; Staff Ex. 4 at 16:7-8.

<sup>415</sup> Staff Ex. 4 at 16:5-6.

<sup>416</sup> *Id.* at 16:15-18.

<sup>417</sup> Docket No. 46449, Order on Rehearing at Finding of Fact 314.

<sup>418</sup> Staff Ex. 4 at 16:13-15.



base rate increases for CCOSS classes, these increases were capped at levels below the level of rate caps recently approved by the Commission. As seen in the table below, SWEPCO capped gross rate increases at 43.26%. However, the actual increases net of TCRF and DCRF revenues are far lower than 43.26% for several classes with current rates very far below cost.

Class	Cost Based % Change	Target Net Base % Change	Target Gross Base % Change
Cotton Gin	105.52%	35.42%	43.26%
Oilfield Secondary	83.80%	42.93%	43.26%
Public Street and Hwy Lighting	223.32%	32.39%	43.26%

Additionally, SWEPCO's rate moderation proposal does not achieve significant movement towards cost for several classes within SWEPCO's CCOSS. Similar to its prior rate cases, SWEPCO's revenue distribution plan uses major rate class groupings to combine numerous classes.<sup>419</sup> SWEPCO then used its CCOSS study to develop the rate design revenue targets for each class.<sup>420</sup> In developing its targets, SWEPCO applied rate moderation or gradualism to three rate classes: Cotton Gin, Oilfield Secondary, and Public Street and Highway Lighting.<sup>421</sup> SWEPCO notes that this approach creates a subsidy paid for by the other classes that share the same major rate class grouping by setting their rates above cost.<sup>422</sup> As seen in the table above, SWEPCO's proposed rate moderation results in rate increases for Cotton Gin, Oilfield Secondary, and Public Street and Highway Lighting that are well below the increases required to set rates just, reasonable, and equitable rates consistent with cost causation.

It is important for rates to be based on cost as required under 16 TAC § 25.234.<sup>423</sup> The term "cost-based rates" has routinely been interpreted as "rates set at cost" and the Commission is "determine[d] to move all classes to cost as quickly as possible."<sup>424</sup> In fact, "the Commission has

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<sup>419</sup> SWEPCO Ex. 55 at 4:10-12.

<sup>420</sup> SWEPCO Ex. 32 at 10:10-13.

<sup>421</sup> SWEPCO Ex. 55 at 8:1-9.

<sup>422</sup> Id. at 8:9-10.

<sup>423</sup> Staff Ex. 4 at 22:6-8.

<sup>424</sup> Docket No. 46449 Proposal for Decision at 356; *Application of AEP Texas Inc. for Authority to Change Rates*, Docket No. 49494, Proposal for Decision at 304 (Nov. 12, 2019).

often stated that one of its primary responsibilities in setting rates is ensuring that those rates are, to the greatest extent reasonable, consistent with cost causation.”<sup>425</sup>

As Mr. Narvaez explains, rates set at cost advance economic efficiency and rate stability and allow the revenues recovered by a utility to match the cost incurred by customer usage even as that customer usage changes over time.<sup>426</sup> However, when rates are not set at cost, this leads to subsidized rates for some customers and rates that are above cost for other customers.<sup>427</sup> The resulting non-cost-based rate structure “would provide price signals that no longer reflect the actual cost to serve each group of customers, thus promoting inefficient usage of the utility’s system by encouraging usage of the utility system by those customers whose rates are below-cost while discouraging usage of the utility system by those customers whose rates are above-cost.”<sup>428</sup> Over time, a rate structure that is not based on cost can lead to a growing gap between revenue recovery and costs as was the case in SWEPCO’s previous rate case.”<sup>429</sup>

However, rate moderation, or gradualism, is appropriate when movement to cost would result in an increase that is “so out of proportion or harsh to a particular class . . . .”<sup>430</sup> When rate moderation or gradualism is applied, costs allocated to one rate class in the cost allocation phase are [] distributed to other rate classes that are less susceptible to rate shock.”<sup>431</sup> The gradualism proposal adopted in Docket No. 46449, caps revenue increases for any individual class at 43%.<sup>432</sup> Both Staff and SWEPCO apply this rate moderation or gradualism methodology as part of their revenue distribution plan particularly with respect to three rate classes – Cotton Gin, Oilfield Secondary, and Public Street and Highway Lighting.<sup>433</sup> However, the gradualism or rate

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<sup>425</sup> Docket No. 49494 Proposal for Decision at 295.

<sup>426</sup> Staff Ex. 4 at 22:7-12.

<sup>427</sup> *Id.* at 22:11-19.

<sup>428</sup> *Id.* at 22:14-19.

<sup>429</sup> *Id.* at 22:19-22.

<sup>430</sup> *Application of Entergy Texas, Inc. for Authority to Change Rates, Reconcile Fuel Costs, and Obtain Deferred Accounting Treatment*, Docket No. 39896, Proposal for Decision at 284 (July 6, 2012).

<sup>431</sup> Docket No. 46449 Proposal for Decision at 352.

<sup>432</sup> Staff Ex. 4 at 23:18-23; SWEPCO Ex. 55 at 8:6-11.

<sup>433</sup> Staff Ex. 4 at 23:17-23 - 25:1-15; SWEPCO Ex. 55 at 8:1-12.

moderation exception does not intend for a group of customers to be perpetually away from cost.<sup>434</sup> Rather, the intention is for all classes to eventually arrive at cost-based rates.<sup>435</sup> For the past ten years, the only fully-litigated rate cases where the Commission has approved gradualism are the last two SWEPCO rate cases.<sup>436</sup>

Unlike SWEPCO's proposal for revenue distribution, Staff's gradualism proposal progressively moves rates to the Commission's goal of having rates set at cost while recognizing that full movement to cost in one step would be harsh to particular customer classes. Staff's revenue distribution proposal is a "multi-year phase-in mechanism that would allow for a gradual movement towards cost-based rates for all classes...."<sup>437</sup> This revenue distribution plan, shown in Mr. Narvaez's direct testimony and discussed below, consists of a phase-in approach that gradually moves rates towards cost. The revenue distribution methodology applied within each phase is consistent with the approved revenue distribution methodology adopted by the Commission in Docket No. 46449.<sup>438</sup> Under Staff's CCOSS, rates would be set at cost after four phases.

In Phase I, starting with the Commission approved CCOSS, revenue increases, net of TCRF and DRCR revenues, for any individual class would be capped at 43%.<sup>439</sup> Then residual revenues for the rate classes subject to the 43% cap are reallocated proportionally among the classes within the rate bundle that are not subject to the 43% cap.<sup>440</sup> For Staff's proposed CCOSS, the rate classes subject to the 43% cap in this proceeding are Cotton Gin, Oilfield Secondary Service, and the Public Street and Highway Lighting classes.<sup>441</sup>

This process continues in Phases II through IV, so Phase II caps revenue increases for any individual rate class, net of changes in TCRF and DCRF revenues, at an additional 43% or at 86% net increase from present test-year base-rate related revenues.<sup>442</sup> Each of the phases rates would

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<sup>434</sup> Tr. at 1430:13-16 (Narvaez Redirect) (May 26, 2021).

<sup>435</sup> Tr. at 1430:18 (Narvaez Redirect) (May 26, 2021).

<sup>436</sup> Tr. at 1429:9-12 (Narvaez Redirect) (May 26, 2021).

<sup>437</sup> Staff Ex. 4 at 23:14-15.

<sup>438</sup> *Id.* at 23:12-23.

<sup>439</sup> *Id.* at 23:20-23.

<sup>440</sup> *Id.* at 23:23 to 24:1-2.

<sup>441</sup> *Id.* at 24:2-4.

<sup>442</sup> *Id.* at 24:10-14.

be effective a year after the previous phases rates.<sup>443</sup> The rates for all classes within the Residential, Commercial and Industrial, and Lighting rate bundles would all be set at cost during Phase II since for Staff's proposed CCROSS the net revenue increases for all classes within these bundles are below the cumulative 86% cap for Phase II.<sup>444</sup> One rate class, the Public Street and Highway Lighting class would be capped at a cumulative 86% net increase in Phase II, and the residual revenue amount, now less than in Phase I, would be allocated proportionally among the other classes within the Municipal rate bundle.<sup>445</sup>

Similarly, Phase III rates would cap revenue increases for any individual rate class, net of changes in TCRF and DCRF revenues, another at 43% for a 129% net increase from present test-year base-rate related revenues.<sup>446</sup> Since the Public Street and Highway Lighting Class would still be above the cumulative Phase III 129% cap at Staff's proposed CCROSS, the residual revenue amount would again be allocated proportionally among the other classes within the Municipal rate bundle.<sup>447</sup> The residual revenue amount would still be less than in Phase I or Phase II.<sup>448</sup> Phase IV applies the same methodology as the previous phases and the revenue increases for any individual class are capped at a cumulative 172% net increase from present test-year base-rate related revenues.<sup>449</sup> Since, the Public Street and Highway Lighting's cost-based net revenue increase is below 172% cap at Staff's proposed CCROSS, all rates would be set at cost by Phase IV.<sup>450</sup>

Staff's revenue distribution plan using a phase-in gradualism approach has been approved by the Commission for two large water utilities, SWWC Utilities Inc. and Undine Texas LLC.<sup>451</sup> Although this approach has not previously been proposed for an electric utility, the methodology is reasonably applicable to electric utilities, and there is no good reason not to do so.<sup>452</sup>

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<sup>443</sup> *Id.* at 24:22, 25:9, 25:15.

<sup>444</sup> *Id.* at 24:13-16.

<sup>445</sup> *Id.* at 24:16-21.

<sup>446</sup> *Id.* at 25:1-4.

<sup>447</sup> *Id.* at 25:4-9.

<sup>448</sup> *Id.* at 25:7.

<sup>449</sup> *Id.* at 25:10-13.

<sup>450</sup> *Id.* at 25:13-15.

<sup>451</sup> *Id.* at 25:18-19.

<sup>452</sup> Staff Ex. 4 at 25:17-18; Tr. at 1433:19-21 (Narvaez Redirect) (May 26, 2021).

A portion of Staff's revenue distribution plan showing the movement of the Cotton Gin, Oilfield Secondary, and Public Street and Highway Lighting classes towards cost-based rates is reproduced below.<sup>453</sup>

Class	Cost Based % Change	Phase I Target Net % Change	Phase II Target Net % Change	Phase III Target Net % Change	Phase IV Target Net % Change
Cotton Gin	65.63%	43.00%	65.83%	65.83%	65.83%
Oilfield Secondary	68.10%	43.00%	68.10%	68.10%	68.10%
Public Street and Hwy Lighting	170.45%	43.00%	86.00%	129.00%	170.45%

#### **B. Rate Design and Tariff Changes [PO Issues 60, 61, 62]**

The ALJs should adopt Staff's proposed rate design as included in the direct testimony of Mr. Narvaez. Staff's proposed rate design is based on its CCOSS and its proposed revenue distribution. Additionally, the ALJs should reject SWEPCO's proposal to revise its General Services tariff to remove the provision that restricts availability of the rate schedule to customers with a maximum demand that does not exceed 50kW. In adopting Staff's rate design plan, the ALJs should adopt Staff's recommendation requiring SWEPCO to eliminate the potential for customer migration by its next major rate proceeding. Finally, the ALJs should reject East Texas Salt Water Disposal's (ETSWD) rate design proposal to adjust SWEPCO's CCOSS to reflect load changes due to the COVID-19 pandemic.

As part of its rate design, SWEPCO proposes changes to its General Services Tariff.<sup>454</sup> Specifically, SWEPCO proposes to remove a tariff provision that restricts the availability of taking service under this tariff to customers with a maximum demand not exceeding 50kW.<sup>455</sup> The SOAH ALJs should reject SWEPCO's proposal because it could lead to the migration of customers from the Lighting and Power Tariff to the General Services Tariff since the Lighting and Power

<sup>453</sup> Staff Ex. 4 at 41-44, Attachment AN-6.

<sup>454</sup> SWEPCO Ex. 32 at 19:1-6.

<sup>455</sup> *Id.* at 19:1-6.

Tariff would be less economical than the General Services Tariff.<sup>456</sup> SWEPCO argues that other utilities such as Entergy allow for rate migration between two general service tariffs.<sup>457</sup> However, Entergy's situation is different given that "the rates were set at cost in that Entergy – Entergy's last fully litigated case."<sup>458</sup> As Staff witness Mr. Narvaez explains in his direct testimony, "while it is normal to expect that the number of customers taking service under a specific tariff to vary somewhat from year to year, structural tariff changes designed to encourage customer migration from tariffs that are less economical is a significant change that could drastically alter the cost of service of the two General Service classes."<sup>459</sup> Additionally, rate migration provides special treatment to some customers, which "could result in cross-subsidization between classes as we've seen with SWEPCO in the past." This outcome undermines the Commission's ability to establish cost-based rates that are just and reasonable.<sup>460</sup> The concern of special treatment to customer was noted in SWEPCO's previous rate proceeding.<sup>461</sup> Furthermore, as SWEPCO has noted previously, rate migration could lead to SWEPCO not recovering its intended revenue requirement.<sup>462</sup> As a result of these concerns, in addition to rejecting SWEPCO's proposal to increase customer migration by expanding the applicability of the General Service Tariff, Staff recommends that the ALJs require SWEPCO to revise its tariff in its next major rate proceeding to eliminate the potential for customer migration between base rate classes.<sup>463</sup> Contrary to assertions in SWEPCO's rebuttal, this approach would not prohibit customers from participating in Time-of-Use rate options, as such options are appropriately applied within base rate classes and do not constitute separate base rate classes.<sup>464</sup>

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<sup>456</sup> Staff Ex. 4 at 26:15-19, 27:17-20.

<sup>457</sup> SWEPCO Ex. 55 at 19:4-5.

<sup>458</sup> Tr. at 1428: 24-25 to 1429:1 (Narvaez Redirect) (May 26, 2021).

<sup>459</sup> Staff Ex. 4 at 27:17-21.

<sup>460</sup> Tr. 1426: 7-10 (Narvaez Redirect) (May 26, 2021); Staff Ex. 4 at 28:18-20 to 29:1-2.

<sup>461</sup> 46449 PFD at 358.

<sup>462</sup> Tr. at 1426:11-22 (Narvaez Redirect) (May 26, 2021); Docket No. 46449, Proposal for Decision at 358.

<sup>463</sup> Staff Ex. 4 at 29:6-11.

<sup>464</sup> SWEPCO Ex. 55 at 19:5-7.

Additionally, ETSWD proposes that SWEPCO's CCOSS be adjusted to reflect load changes due to the COVID-19 pandemic.<sup>465</sup> Specifically, ETSWD depicts its proposal as adjusting SWEPCO's CCOSS to reflect "known and measurable pro-forma adjustments related to COVID-19 pandemic impacts, including changes to electricity usage."<sup>466</sup> The ALJs should reject ETSWD's proposal. First, ETSWD does not provide the information necessary to make the adjustment to SWEPCO's CCOSS.<sup>467</sup> The data provided only shows weather normalized sales for four customer groups identified as residential, commercial, industrial, and other retail.<sup>468</sup> The information needed to properly implement such an adjustment would, at minimum, require data for each of the nineteen different classes included in SWEPCO's CCOSS.<sup>469</sup> Therefore, it would not be possible to implement this adjustment during the PFD or Commission number runs since the needed data is not in the record in this case.<sup>470</sup> Additionally, ETSWD's proposal does not comport with the Commission's known and measurable standard because the adjustment is not reasonably quantifiable and does not describe a situation that is apt to prevail in the future.<sup>471</sup> As discussed in Mr. Narvaez's cross-rebuttal testimony, it is not possible to know what retail sales would have been but for the pandemic, and as SWEPCO states it is difficult to fully measure the impact of COVID-19 sales on SWEPCO's Texas retails sales.<sup>472</sup> Furthermore, the changes in electricity usage recorded since the pandemic began reflect conditions that were unique to the first few months of the COVID-19 pandemic.<sup>473</sup> These are not conditions that are apt to prevail in the future. Lastly, ETSWD's proposal fails to account for attendant impacts associated with the proposed adjustments.<sup>474</sup> In other words, "[i]f it were appropriate to reduce the allocation to certain classes

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<sup>465</sup> Direct Testimony of Kit Pevoto, ETSWD Ex. 1 at 14:4-9.

<sup>466</sup> *Id.* at 14:7-8.

<sup>467</sup> Cross Rebuttal Testimony of Adrian Narvaez, Staff Ex. 4b at 5:5-6.

<sup>468</sup> *Id.* at 5:15-18.

<sup>469</sup> *Id.* at 5:18-20.

<sup>470</sup> Tr. at 1429:22-25 (Narvaez Redirect) (May 26, 2021).

<sup>471</sup> Staff Ex. 4b at 6:18-21 to 7:1-2.

<sup>472</sup> *Id.* at 7:15-16.

<sup>473</sup> *Id.* at 8:7-9.

<sup>474</sup> *Id.* at 8:19-21.

due to the pandemic...then one should also reduce the billing determinants for those classes.”<sup>475</sup> By accounting for the attendant impacts, including the effect of lower billing determinants, it is possible that the net effect could actually increase rates for classes that saw a reduction in usage during 2020 due to the pandemic.<sup>476</sup> Therefore, ETSWD’s proposal to adjust SWEPCO’s CCOSS to reflect changes in electricity usage due to the COVID-19 pandemic should be rejected.

Overall, the ALJs should adopt Staff’s revenue distribution and rate design proposal including the elimination of the potential for customer migration by SWEPCO’s next major rate proceeding. Additionally, the ALJs should reject SWEPCO’s proposed change to the General Services tariff and ETSWD’s proposal to apply adjustments to SWEPCO’s CCOSS as a result of the COVID-19 pandemic.

### **VIII. Baselines for Cost-Recovery Factors [PO Issue 4, 5, 52, 63]**

Staff supports the adoption of its proposed TCRF and DCRF baselines based on the CCOSS approved by the Commission.<sup>477</sup>

#### **A. Interim Transmission Cost of Service**

Staff does not address this section since under 16 TAC § 25.192(a), an interim transmission cost of service (TCOS) applies only for utilities serving Electric Reliability Council of Texas (ERCOT) region. Since SWEPCO does not serve in the ERCOT region there is no wholesale rates SWEPCO would update via an interim TCOS.

#### **B. Transmission Cost Recovery Factor**

Staff addresses SWEPCO’s proposal to exclude TCRF revenues Staff’s evaluation of SWEPCO’s proposed base rate increase in Section VII.B above. Staff also addresses SWEPCO’s proposal to defer net SPP charges to a future TCRF or base-rate proceeding in Section IV.A.3 above.

#### **C. Distribution Cost Recovery Factor**

Staff addresses SWEPCO’s proposal to exclude DCRF revenues in Staff’s evaluation of SWEPCO’s proposed base rate increase in Section VII.B above.

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<sup>475</sup> *Id.* at 9:12-15.

<sup>476</sup> *Id.* at 9:15-19.

<sup>477</sup> Staff Ex. 4 at bates 37-40, Attachment AN-5.



## **IX. Reasonableness & Recovery of Rate Case Expenses [PO Issues 26, 27,28]**

The ALJs should allow recovery of rate case expenses in the amount consistent with the recommendations below and Ms. Stark's Supplemental Direct Testimony regarding rate case expenses due to be filed on July 20, 2021. SWEPCO requests recovery of its reasonable rate-case expenses incurred in this proceeding as well as those expenses it pays to reimburse intervening municipalities, Cities Advocating Reasonable Deregulation (CARD).<sup>478</sup> SWEPCO also seeks to recover expenses associated with its most recent TCRF filing, Docket No. 49042;<sup>479</sup> its pending fuel reconciliation, Docket No. 50997;<sup>480</sup> as well as appellate expenses related to its last two base rate proceedings, Docket No. 40443 and Docket No. 46449.<sup>481</sup>

### ***Reasonableness of Rate Case Expenses***

SWEPCO has submitted, and Ms. Stark has reviewed, \$1,755,486 in expenses associated with these proceedings that were recorded on SWEPCO's books through February 28, 2021.<sup>482</sup> Additionally, CARD submitted its own rate-case expenses for the same proceedings through March 31, 2021 totaling \$648,986, which Ms. Stark has reviewed as well.<sup>483</sup> Ms. Stark identified \$60,925 as overlapping or duplicate expenses between either the amounts of rate-case expense requested by SWEPCO and CARD in this proceeding or between this proceeding and the amount that was requested and is pending approval in Docket No. 50997.<sup>484</sup> SWEPCO agrees that \$15,468 of this amount should be removed from its request in this proceeding as those expenses are being addressed in Docket No. 50997.<sup>485</sup> SWEPCO disagrees that the remaining \$45,457 will be double-recovered because CARD does not recover rate-case expenses directly from customers, but is

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<sup>478</sup> Direct Testimony of Lynn Ferry-Nelson, SWEPCO Ex. 5 at 24:13-15.

<sup>479</sup> *Application of Southwestern Electric Power Company to Amend its Transmission Cost Recovery Factor*, Docket No. 49042, Order (July 18, 2019).

<sup>480</sup> *Application of Southwestern Electric Power Company for Authority to Reconcile Fuel Costs*, Docket No. 50997 (pending).

<sup>481</sup> SWEPCO Ex. 5 at 24:16-19.

<sup>482</sup> Supplemental Direct Testimony of Ruth Stark, Staff Ex. 3b at 2:18 – 3:1.

<sup>483</sup> *Id.* at 3:2-5.

<sup>484</sup> *Id.* at 6:13-22.

<sup>485</sup> Supplemental Rebuttal Testimony of Lynn Ferry-Nelson, SWEPCO Ex. 35 at 2, footnote 3.

instead reimbursed by SWEPCO.<sup>486</sup> Staff agrees that the \$45,457 is recoverable by SWEPCO and only sought to separately identify the expenses incurred by SWEPCO as distinguished from those incurred by CARD. With this clarification, Ms. Stark and Ms. Ferry-Nelson are in agreement that SWEPCO's request for its own expenses is \$1,694,561.<sup>487,488</sup>

Additionally, Ms. Stark proposes an adjustment of (\$6,868) associated with this proceeding (Docket No. 51415) and an adjustment of (\$43,884) to SWEPCO's requested expenses associated with the appeal of Docket No. 40443 based on the criteria outlined in 16 TAC § 25.245(c). This results in a combined adjustment of (\$50,752) to SWEPCO's request based on the first criterion set out in this section of the rule which is:

- (1) the extent to which the evidence shows that the fees paid to, tasks performed by, or time spent on a task by an attorney or other professional were extreme or excessive

Ms. Stark's proposed disallowance of \$50,752 is related to the hourly billing rate for certain SWEPCO legal expenses in the two proceedings<sup>489</sup>. With respect to Docket No. 51415, SWEPCO incurred \$12,423 of legal expenses for services provided by Eversheds Sutherland US, LLP consisting of 10.1 hours billed at an hourly rate of \$1,230.<sup>490</sup> For the appeal of Docket No. 40443, SWEPCO incurred legal expenses for services provided by Baker Botts, LLP, a portion of which included \$96,354 for 95.4 hours billed at an hourly rate of \$1,010.<sup>491</sup> Ms. Stark testifies that for the past few years, Staff has consistently recommended that any amount billed above an hourly rate of \$550 an hour is excessive under 16 TAC § 25.245(c)(1) and that her adjustment of (\$50,752) is the product of multiplying the number of hours billed in each case by the portion of the hourly billing rate that is above \$550.<sup>492</sup>

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<sup>486</sup> *Id.* at 3:5-20.

<sup>487</sup> Staff Ex. 3b at 7:1-2.

<sup>488</sup> Ferry-Nelson supplemental rebuttal at 4:1-2.

<sup>489</sup> *Id.* at 7:15-16.

<sup>490</sup> *Id.* at 7:16-18.

<sup>491</sup> *Id.* at 7:18-21

<sup>492</sup> *Id.* at 7:21-24.

Ms. Stark testifies that in commenting on the pending adoption of 16 TAC § 25.245, the Commissioners commented on the need to start scrubbing attorney's fees, the need to set up a more robust process for reviewing attorney's fees, and that such fees need to be proven up with real evidence from credible experts.<sup>493</sup> Ms. Stark cites, as support for the \$550 cap on attorney fees a memorandum (and subsequent follow-up) issued by the Office of the Attorney General of Texas (OAG) to state agencies, university systems, and institutions of higher education outlining policies and procedures relating to the retention of outside legal counsel which stated that unless expressly approved, the hourly rate for attorneys shall not exceed \$525 per hour.<sup>494</sup> Ms. Stark testifies that as the state's legal counsel, the Attorney General has determined that legal services provided on behalf of the taxpayers of the State of Texas should be capped at \$525 per hour.<sup>495</sup> Ms. Stark further testifies that the majority of the legal billings requested by SWEPCO and CARD in this proceeding relate to services provided by the firms DWMR, Herrera Law & Associates, PLLC, and Scott, Douglass & McConnico, LP are set at hourly attorney billing rates ranging from \$250 per hour to \$550 per hour.<sup>496</sup>

Ms. Stark notes that the Commission has approved a cap on attorney fees in some settled cases but has yet to rule on the issue in a contested proceeding.<sup>497</sup> Ms. Stark also points out that the Commission's order adopting 16 TAC § 25.245 noted that "adopting clear evidentiary standards and specific criteria for the review and determination of the reasonableness of rate-case expenses will incentivize utilities and municipalities to act more like self-funded litigants, while still providing for recovery of reasonable rate-case expenses."<sup>498</sup> Ms. Stark cites as additional support the Proposal for Decision (PFD) in Docket No. 45979,<sup>499</sup> which reiterates this point:

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<sup>493</sup> *Id.* at 8:1-25.

<sup>494</sup> *Id.* at 8:29 -9:5. at 7.

<sup>495</sup> *Id.* at 9:5-7.

<sup>496</sup> *Id.* at 9:7-10.

<sup>497</sup> *See Application of El Paso Electric Company to Change Rates*, Docket No. 46831, Finding of Fact No. 64 (Dec. 18, 2017).

<sup>498</sup> Project No. 41622, Order Adopting Rule § 25.245 at 13-14.

<sup>499</sup> *Review of Rate Case Expenses Incurred by Sharyland Utilities, L.P. in Docket No. 45414*, Docket No. 45979, Order of Dismissal (Aug. 8, 2019).

Setting attorneys' fees in an RCE case based on the upper end of hourly rates charged by large, national law firms would remove the intended incentive for regulated public utilities to act more like self-funded litigants . . . National law firms may charge \$600 and more per hour, and Sharyland is free to hire such firms to represent it before the PUC, but that does not mean that rates in that range are reasonable for practitioners before the PUC, and Sharyland's captive customers should not be expected to cover hourly fees at and above \$550 per hour.<sup>500</sup>

Ms. Stark explains that while the Commission ultimately dismissed the proceeding in Docket No. 45979 cited above, the PFD in that case is still instructive:

The ALJ agrees with Staff and OPUC that, in general, a cap on hourly fees charged by attorneys in utility rate cases before the Commission is appropriate and, in this case, the record supports a \$550 per hour cap . . . While Rule 25.245(c)(1) does not specify a cap on attorneys' fees, it contemplates that fees paid to an attorney or other professional could be "extreme or excessive." Otherwise, there would be no purpose for Rule 25.245 to identify the level of fees paid to an attorney (or other professional) as a consideration under that rule.<sup>501</sup>

Finally, Ms. Stark points out that the PFD observed:

There is no evidence in the record of a fully and finally litigated case in which the Commission was asked to determine if an attorney's fee at or above \$550 was reasonable. On the other hand, there is a good deal of evidence in the record from Staff's and OPUC's testimony showing that there are a number of highly experienced and qualified attorneys in the PUC bar who charge well under \$550 per hour.<sup>502</sup>

Ms. Stark notes that the direct and rebuttal testimonies of Ms. Ferry-Nelson, wherein SWEPCO provided support for the requested rate-case expenses, do not specifically address the services provided by either Eversheds Sutherland or Baker Botts or the reasonableness of their hourly billing rates.<sup>503</sup> It was not until SWEPCO filed supplemental rebuttal testimony, after Ms. Stark proposed the disallowances related to hourly billing rates and after the discovery deadline in this proceeding, that SWEPCO even concerned itself with describing the services provided by the

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<sup>500</sup> Docket No. 45979, Proposal for Decision at 42 - 43 (Oct. 29, 2018)

<sup>501</sup> *Id.* at 41-42.

<sup>502</sup> *Id.* at 42.

<sup>503</sup> Staff Ex. 3b at 11:1-3.

individuals in question, describing the issues they addressed, and addressing the rates that they charged. SWEPCO did not provide this information until its supplemental rebuttal testimony even though 16 TAC § 25.245 clearly requires it to provide such information:

- (b) **Requirements for claiming recovery of or reimbursement for rate-case expenses.** A utility or municipality requesting recovery of or reimbursement for its rate-case expenses shall have the burden to prove the reasonableness of such rate-case expenses by a preponderance of the evidence. A utility or municipality seeking recovery of or reimbursement for rate-case expenses shall file sufficient information that details and itemizes all rate-case expenses, including, but not limited to, evidence verified by testimony or affidavit, showing:
- (1) the nature, extent, and difficulty of the work done by the attorney or other professional in the rate case;
  - (2) the time and labor required and expended by the attorney or other professional;
  - (3) the fees or other consideration paid to the attorney or other professional for the services rendered;
  - (4) the expenses incurred for lodging, meals and beverages, transportation, or other services or materials;
  - (5) the nature and scope of the rate case, including:
    - (A) the size of the utility and number and type of consumers served;
    - (B) the amount of money or value of property or interest at stake;
    - (C) the novelty or complexity of the issues addressed;
    - (D) the amount and complexity of discovery;
    - (E) the occurrence and length of a hearing; and
  - (6) the specific issue or issues in the rate case and the amount of rate-case expenses reasonably associated with each issue.

As noted above, Ms. Stark testifies that for the past few years, Commission Staff has consistently recommended that any amount billed above an hourly rate of \$550 an hour is excessive under 16 TAC § 25.245(c)(1), so it should not have come as a surprise to SWEPCO that these hourly fees would be an issue in this proceeding. Because SWEPCO did not provide this information when it was making its claim for reimbursement of these expenses as required by 16 TAC § 25.245(b) outlined above, and instead waited until after the discovery deadline in this proceeding had passed to provide said information, SWEPCO should not be allowed to recover rate case expenses above \$550 an hour. Further, Ms. Stark testified that her recommendation does

not limit SWEPCO from paying higher rates for legal counsel above \$550 an hour, only that there should be a cap on the amount that should reasonably be recovered from ratepayers.<sup>504</sup>

With respect to the rate-case expenses of CARD, Ms. Stark testifies that CARD requested \$6,321 for expenses associated with Docket No. 47141 that were incurred after April 13, 2020, and the amended unanimous settlement in that proceeding capped CARD's reimbursement of such expenses at \$2,500:

The parties agreed that SWEPCO would recover \$5,429,804.52 in rate-case expenses. This black-box amount includes reimbursement to CARD in the amount of \$1,086,322.14 through April 13, 2020. In addition, the black-box amount includes reimbursement to CARD for actual expenses incurred in this docket after April 13, 2020 but caps that reimbursement at \$2,500.<sup>505</sup>

Additionally, the agreement provided that SWEPCO and CARD would not seek any additional recovery for expenses associated with Docket No. 47141:

SWEPCO and CARD agreed not to request any additional recovery for rate-case expenses incurred in this docket, in litigation before the Commission in Docket Nos. 40443 and 46449, and in Docket Nos. 48233 and 47553.<sup>506</sup>

Because the Commission's order in Docket No. 47141 prohibits recovery of any additional expenses related to that proceeding, CARD's requested rate-case expenses should be adjusted by (\$6,321).<sup>507</sup>

In summary, Ms. Stark recommends that \$1,643,809 of SWEPCO's rate-case expenses and \$642,665 of CARD's expenses are eligible for recovery.<sup>508</sup> According to Ms. Stark and based on her initial review of the requested expenses, these expenses appear to be reasonable on their face and in compliance with 16 TAC § 25.245. However, Ms. Stark notes that one of the requirements of this rule is that rate case expenses as a whole must not be disproportionate, excessive, or

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<sup>504</sup> *Id.* at 11:4-8.

<sup>505</sup> Docket No. 47141, Finding of Fact No. 78.

<sup>506</sup> *Id.* at Finding of Fact No. 79.

<sup>507</sup> Staff Ex. 3b at 12:1-3.

<sup>508</sup> *Id.* at 12:13 – 13:2.

unwarranted in relation to the nature and scope of the rate case addressed by the evidence.<sup>509</sup> As the expenses reviewed to date represent only part of the expected total rate-case expenses for this proceeding, that ultimate determination cannot be made at this time.<sup>510</sup>

### ***Recovery of Rate-case expenses***

The ALJs should not adopt SWEPCO's proposal to recover projected rate case expenses, but should allow recovery of rate case expenses through July 6, 2021 consistent with SOAH Order No. 13. SWEPCO proposes to recover, through its rate case surcharge rider, its actual rate-case expenses for this proceeding up to a cut-off date and requests that its projected expenses after the cut-off date also be included in the rider subject to a review for reasonableness and adjustment for over-or under-collection in the next proceeding in which its rate-case expenses are addressed.<sup>511</sup> Ms. Stark recommends that the Commission not allow recovery of any projected rate-case expenses related to this proceeding through SWEPCO's rate case surcharge rider.<sup>512</sup> According to Ms. Stark, the Commission has previously rejected the recovery of projected or estimated rate-case expenses.<sup>513</sup> In adopting 16 TAC § 25.245 it explained:

The commission declines to adopt Oncor Cities' proposal relating to the reimbursement of a municipality's expected future rate-case expenses. Recent commission precedents, including Docket No. 40295, expressly state that approving estimated future rate-case expenses for municipal parties is not in the public interest. Accordingly, the commission declines to adopt any provision that would permit the approval of estimated future expenses.<sup>514</sup>

The order in Docket No. 40295 cited above states:

Consistent with Commission precedent, it is not in the public interest to permit recovery of estimated rate-case expenses.<sup>515</sup>

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<sup>509</sup> 16 TAC § 25.245(c)(5).

<sup>510</sup> Staff Ex. 3 at 57:11-13

<sup>511</sup> SWEPCO Ex. 5 at 26:7-25.

<sup>512</sup> Staff Ex. 3b at 13:9-10.

<sup>513</sup> *Id.* 13:10-12.

<sup>514</sup> Project No. 41622, Order at 142.

<sup>515</sup> *Application of Entergy Texas, Inc. for Rate Case Expenses Pertaining to PUC Docket No. 39896*, Docket No. 40295, Conclusion of Law No. 10 (May 21, 2013).

SOAH Order No. 13 establishes a procedure in this proceeding for SWEPCO and CARD to file additional updates to their rate-case expenses incurred in this proceeding through July 6, 2021.<sup>516</sup> Ms. Stark testifies that allowing SWEPCO and CARD to update their rate-case expenses after the hearing will limit the amount of trailing rate-case expenses resulting from this proceeding that could be subject to review and recovery in a future proceeding.<sup>517</sup> Ms. Stark recommends that the Commission authorize SWEPCO to establish a regulatory asset to record both SWEPCO's and CARD's trailing rate-case expenses from this proceeding.<sup>518</sup>

**X. Other Issues [including but not limited to PO Issues]**

**A. Additional issues**

The ALJs should adopt Staff's recommendations regarding additional issues below consistent with the discussion in those sections.

***Factoring Expense***

SWEPCO sells its accounts receivable on a daily basis to an affiliate, AEP Credit.<sup>519</sup> The effect of this arrangement is that SWEPCO receives its revenue quicker than it would if it had to wait for its customers to remit payments when their bills are actually due.<sup>520</sup> This practice is commonly referred to as factoring and the fees paid by SWEPCO to AEP Credit for this service are factoring expenses.<sup>521</sup> SWEPCO presents its factoring expense in two parts. First, it adjusts its test year factoring expense based on adjustments to test year base and fuel revenues and its requested return on common equity in this proceeding to reach an adjusted test year factoring

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<sup>516</sup> SOAH Order No. 13 at 1 (May 27, 2021).

<sup>517</sup> Staff Ex. 3b at 14:4-8.

<sup>518</sup> *Id.* at 14:8-10.

<sup>519</sup> Staff Ex. 3 at 15:8.

<sup>520</sup> *Id.* at 15:8-10.

<sup>521</sup> *Id.* at 15:10-12.



expense.<sup>522</sup> SWEPCO then uses the effective factoring rate derived from that calculation to increase factoring expense based on its requested revenue deficiency.<sup>523</sup>

SWEPCO uses three components (its proposed effective carrying cost rate, effective bad debt rate, and banking fee) to reach its proposed effective factoring rate of 0.521277%.<sup>524</sup> As shown in SWEPCO's calculation, the carrying charge factor consists of a debt component and an equity component.<sup>525</sup> Ms. Stark proposes no change to SWEPCO's calculated debt component.<sup>526</sup> The equity component of SWEPCO's factoring expense calculation is based on its requested 10.35% return on equity (ROE) multiplied by 5%.<sup>527</sup> Ms. Stark uses the 9.225% ROE recommended in the testimony of Staff witness Mark Filarowicz, which results in a total effective factoring rate of 0.514884%.<sup>528</sup> Ms. Stark recommends that the effective factoring rate ultimately approved should be determined based on the ROE adopted by the Commission in this proceeding.<sup>529</sup> SWEPCO agrees that the final approved ROE should be included in the final factoring rate calculation to properly synchronize factoring expense with the approved revenue requirement.<sup>530</sup>

#### ***Interest on Customer Deposits***

In calculating its requested interest on customer deposits, SWEPCO applies the calendar-year 2020 rate of 2.21% for interest on customer deposits set by the Commission in Project No. 45319.<sup>531</sup> Ms. Stark proposes to use the most recent Commission-adopted rate of 0.61% for calendar-year 2021 to calculate interest on customer deposits.<sup>532</sup> This produces her proposed interest on customer deposits expense of \$396,941 and the resulting adjustment of (\$1,041,156) to

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<sup>522</sup> *Id.* at 15:14-17.

<sup>523</sup> *Id.* at 15:17-18.

<sup>524</sup> *Id.* at 15:19-21.

<sup>525</sup> SWEPCO Ex. 1 at WP/A-3.5.

<sup>526</sup> Staff ex. 3 at 16:7-8.

<sup>527</sup> SWEPCO Ex. 1 at WP/A-3.5.

<sup>528</sup> Staff Ex. 3 at 16:10-12.

<sup>529</sup> *Id.* at 16:14-15.

<sup>530</sup> SWEPCO Ex. 36 at 36:15-20.

<sup>531</sup> *Setting Interest Rates for Calendar Year 2020*, Project No. 45319, Order (Nov. 15, 2019).

<sup>532</sup> *Setting Interest Rates for Calendar Year 2021*, Project No. 45319, Order (Nov. 19, 2020).

SWEPCO's request.<sup>533</sup> SWEPCO does not contest updating the interest on customer deposits to reflect the current Commission-approved 2021 interest rate.<sup>534</sup>

***Supplemental Executive Retirement Plan (SERP)***

The ALJs should make an adjustment of (\$93,181) to remove the SERP expenses from SWEPCO's requested revenue requirement.

Removal of SWEPCO's SERP expenses complies with the Commission's finding in Docket No. 40443 that these expenses are not reasonable or necessary.<sup>535</sup> SWEPCO claims that it removed its SERP expenses consistent with this Commission precedent,<sup>536</sup> but when asked to explain where it was removed in the requested revenue requirement, SWEPCO pointed to its Application at WP A-3.10 (Pension Expense).<sup>537</sup> A review of the referenced workpaper and the test year end trial balance at Schedule A-4 shows that SWEPCO subtracted the SERP expenses from a pension expense balance that did not include them, so SWEPCO's requested revenue requirement still includes its SERP expenses.<sup>538</sup> Ms. Stark's adjustment of (\$93,181) is necessary to correctly remove the SERP expenses from SWEPCO's requested revenue requirement and to correctly calculate the pension expense adjustment discussed below.<sup>539</sup> SWEPCO does not contest Ms. Stark's adjustment to remove SERP expenses from its requested revenue requirement.<sup>540</sup>

***Pension Expense***

Staff urges the ALJs to find that the adjustment to SWEPCO's test-year pension expense should be calculated by reducing only the service cost component of SWEPCO's pro-forma pension expense by the actual test year payroll capitalization factor and then subtracting the actual test year pension expense of \$4,414,135.

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<sup>533</sup> Staff Ex. 3 at 17:10-12.

<sup>534</sup> SWEPCO Ex. 36 at 37:1-4.

<sup>535</sup> *Application of Southwestern Electric Power Company for Authority to Change Rates*, Docket No. 40443, Order on Rehearing, Finding of Fact No. 227 (Mar. 6, 2014).

<sup>536</sup> SWEPCOE Ex. 6 at 26:11-13.

<sup>537</sup> Staff Ex. 3 at Attachment RS-12.

<sup>538</sup> *Id.* at 10:8 – 11:16.

<sup>539</sup> *Id.* at 11:16 – 12:2.

<sup>540</sup> SWEPCO Ex. 36 at 35:18-20.

SWEPCO subtracts its SERP expenses of \$7,966 (Service Costs) and \$85,215 (SERP Non Service Costs) from its total test-year pension expense of \$4,414,135 to reach an amount of \$4,320,953 that it labels as its total pension expense per books excluding SERP.<sup>541</sup> SWEPCO then compares this amount with its pro-forma pension expense of \$6,970,767 to reach its pro-forma adjustment to pension expense of \$2,649,813.<sup>542</sup> The first problem with this calculation is that by subtracting the SERP expenses from the test-year pension expense of \$4,414,135, SWEPCO implies that the SERP expenses are included in the pension expenses.<sup>543</sup> However, the SERP expenses are not included in the \$4,414,135 of expenses on SWEPCO's books as shown on its test-year-end trial balance.<sup>544</sup> Subtracting these costs from the total pension expense that does not include them artificially lowers the test year pension expense and increases the difference between the actual test-year pension expense and the pro-forma pension expense.<sup>545</sup> Therefore, SWEPCO's adjustment to pension expense is inflated by the amount of the SERP expenses.<sup>546</sup> Second, SWEPCO applies the expense to capitalization factor to the non-service cost portion of its adjusted pension expense, contrary to a Financial Accounting Standards Board Accounting Update which permits only the service cost component of pension expense to be capitalized.<sup>547</sup> SWEPCO did not address either of these corrections to its pension expense calculation in rebuttal testimony.

SWEPCO did, however disagree with Ms. Stark's use of SWEPCO's test year loading ratio, which is based on estimates rather than the actual payroll capitalization ratio from the test year.<sup>548</sup> According to SWEPCO witness Mr. Baird, the actual payroll capitalization ratio for the test year is a better ratio and is consistent with past cases.<sup>549</sup> Ms. Stark concedes that the use of the actual test year capitalization ratio is more appropriate. Therefore, the adjustment to SWEPCO's test-year pension expense should be calculated by reducing only the service cost

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<sup>541</sup> SWEPCO Ex. 1 at WP A-3.10 (Pension Expense).

<sup>542</sup> *Id.*

<sup>543</sup> Staff Ex. 3 at 11:6-9.

<sup>544</sup> SWEPCO Ex. 1 at Schedule A-4, Account 926.

<sup>545</sup> Staff Ex. 3 at 11:10-13.

<sup>546</sup> *Id.* at 11.13-14.

<sup>547</sup> *Id.* at 12.17-20.

<sup>548</sup> SWEPCO Ex. 36 at 36:1-2.

<sup>549</sup> *Id.* at 36:2-5.

component of SWEPCO's pro-forma pension expense by the actual test year payroll capitalization factor and then subtracting the actual test year pension expense of \$4,414,135.

***Executive Perquisites***

SWEPCO identifies \$12,111<sup>550</sup> of its own executive perquisites and \$8,484<sup>551</sup> allocated by AEPSC that are included in its requested cost of service. The Commission's Order in Docket No. 40443 noted:

The \$16,350 related to executive perquisites should not be included in rates because they provide no benefit to ratepayers and are not reasonable or necessary for the provision of electric service.<sup>552</sup>

The Commission made a similar finding in Docket No. 46449.<sup>553</sup> Consistent with these orders, Ms. Stark includes an adjustment of (\$20,595) to remove these expenses from SWEPCO's requested revenue requirement. SWEPCO does not contest this adjustment.<sup>554</sup>

**C. Cash Working Capital [PO Issue 18]**

Ms. Stark's recommended working cash allowance is based on SWEPCO's methodology and the use of its lead/lag study approved in Docket No. 46449 and incorporates her adjustments to operations and maintenance expenses and taxes.<sup>555</sup> SWEPCO agrees that cash working capital should be updated and synchronized with the final revenue requirement in this case.<sup>556</sup>

**D. Administrative and General O&M Expenses [PO Issue 25]**

SWEPCO notes that it inadvertently included \$46,306 in its requested regulatory commission expenses that should have been removed.<sup>557</sup> Ms. Stark's adjustment of (\$46,306)

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<sup>550</sup> Staff Ex. 3 at Attachment RS-15.

<sup>551</sup> *Id.* at Attachment RS-16.

<sup>552</sup> Docket No. 40443, Order on Rehearing, Finding of Fact No. 221.

<sup>553</sup> Docket No. 46449, Order on Rehearing, Finding of Fact No. 200.

<sup>554</sup> SWEPCO Ex. 6 at 36:6-8.

<sup>555</sup> Staff Ex. 3 at 55:3-7.

<sup>556</sup> SWEPCO Ex. 36 at 28:1-4.

<sup>557</sup> Staff Ex. 3 at Attachment RS-18.

excludes this amount from SWEPCO's requested revenue requirement.<sup>558</sup> SWEPCO agrees with this adjustment.<sup>559</sup>

**L. Should PUC approve requests for waivers? [PO Issue 65]**

The Commission should approve SWEPCO's request for a waiver of the requirement to file Schedule S and perform the related audit in its rate filing package for this docket, in accordance with its request and the Commission's order in Docket No. 50917.<sup>560</sup> The Commission determined that good cause exists to permit SWEPCO to forgo the expense of filing Schedule S and performing the related audit, on the basis that the benefits of requiring the review in this rate case are outweighed by the sizeable costs to consumers involved.<sup>561</sup>

**XI. Conclusion**

Staff respectfully requests the adoption of Staff's recommendations, as SWEPCO's requests exceed that allowed by relevant law. In particular, Staff recommends adoption of its recommended 9.35% ROE, with a 12.5 basis point reduction based on interruptions in service and reliability concerns, resulting in an overall ROE of 9.225%. Staff also recommends rejection of SWEPCO's proposal to earn a return on and of the Dolet Hills plant that will not be used and useful in providing utility service after December 31, 2021 and adoption of Staff's proposal regarding Dolet Hills as outlined in section II.A.1. Additionally, Staff respectfully requests that SWEPCO's proposal to add the NOLC ADFIT asset balance in the amount of \$455,122,940 into rate base be rejected and that amount be removed from rate base.

To address reliability concerns, Staff recommends adoption of its proposals (1) that SWEPCO be ordered to move to a four-year trim cycle for distribution VM; and (2) SWEPCO be ordered to hire an independent contractor to conduct a review of SWEPCO's transmission system and make appropriate recommendations regarding SWEPCO's VM practices, facilities, replacement, and transmission system protection.

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<sup>558</sup> *Id.* at 15:4-5.

<sup>559</sup> SWEPCO Ex. 36 at 36:12-14.

<sup>560</sup> *Application of Southwestern Electric Power Company for Waiver of Rate Filing Package Schedule S*, Docket No. 50917, Order (Dec. 17, 2020).

<sup>561</sup> Docket No. 50917, Commission Staff's Recommendation on Final Disposition at 2,4 (Dec. 17, 2020).

Overall, Staff recommends a Texas retail revenue requirement of approximately \$410 million for SWEPCO and these revenues should be collected from SWEPCO's customers in a manner consistent with Staff's phased-in revenue distribution proposal moving all classes to the Commission's goal of cost-based rates.

**SOAH DOCKET NO. 473-21-0538  
PUC DOCKET NO. 51415**

**CERTIFICATE OF SERVICE**

I certify that, unless otherwise ordered by the presiding officer, notice of the filing of this document was provided to all parties of record via electronic mail on June 17, 2021, in accordance with the Order Suspending Rules, issued in Project No. 50664.

/s/ Robert Dakota Parish  
Robert Dakota Parish