APSC FILED Time: 5/3/2013 11:35:47 AM: Recvd 5/3/2013 11:31:16 AM: Docket 11-050-U-Doc. 71

BEFORE THE ARKANSAS PUBLIC SERVICE COMMISSION

IN THE MATTER OF THE APPLICATION OF AEP SOUTHWESTERN TRANSMISSION COMPANY, INC. FOR RECOGNITION AS A PUBLIC UTILITY WITH POWERS OF EMINENT DOMAIN AND CERTIFICATED FOR THE PUBLIC CONVENIENCE AND NECESSITY TO OWN AND OPERATE TRANSMISSION FACILITIES IN THE STATE OF ARKANSAS AND THE APPLICATION OF SOUTHWESTERN ELECTRIC POWER COMPANY TO TRANSFER CERTAIN SPECIFIED CECPN AUTHORITY AND RESPONSIBILITIES TO AEP SOUTHWESTERN TRANSMISSION COMPANY, INC.	**)))))))))))))**	**Docket 11-050-U**

REDACTED

SUPPLEMENTAL DIRECT TESTIMONY OF

WILLIAM B. MARCUS

ON BEHALF OF

THE ARKANSAS ATTORNEY GENERAL

May 3, 2013

SUPPLEMENTAL TESTIMONY OF WILLIAM B. MARCUS

Q. Have you previously filed testimony in this docket, Mr. Marcus?

A. Yes.

Q What is the purpose of your testimony?

A I respond to the supplemental testimony filed on December 3, 2012 in support of the proposal by AEP Southwestern Transmission Company ("SW Transco") and Southwestern Electric Power Company to establish a new public utility to provide transmission service.

Q Please summarize your recommendation.

A Notwithstanding the supplemental testimony, the Commission should still reject or dismiss this application. The Applicants have still not proven their case on the key point as to whether SW Transco has financial advantages relative to SWEPCO that would overcome the higher rates that SW Transco would provide.

Q Will you summarize the Company's discussion of benefits to ratepayers from the formation of SW Transco.

A Ms. Barton's testimony lays out seven benefits, as follows:

- Approval of AEP Transcos in other jurisdictions have benefited those states;
- Benefits will accrue in Arkansas with AEP's development of transmission projects in Arkansas through the strength and experience that AEP Transmission brings in developing transmission;
- AEP is a low cost provider of Transmission;
- Arkansas ratepayers will benefit by the SW Transco's development and financing arrangement of transmission projects, which will result in an overall lower transmission project cost;
- SW Transco will provide the same level of service that SWEPCO ratepayers have historically been provided;
- Approval of SW Transco is critical to the reliability of the transmission system in Arkansas and will allow AEP to invest more in needed

transmission facilities and free up capital for SWEPCO distribution, transmission and generation projects; and

- Approval of the SW Transco will allow a SWEPCO affiliate to develop projects as opposed to a non-affiliated third-party.

Q Will you provide the foundation of your remaining responses to these questions?

A Just as in the first round of testimony that the Attorney General filed, the fundamental question in our view remains whether SWEPCO itself escapes the Commission's retail rate jurisdiction by joining the Southwest Power Pool (SPP). If so, then rates for SWEPCO transmission will increase in its next rate case regardless of whether SW Transco is formed or not. If not, rate increases would occur due to the formation of SW Transco that would not occur if it is not formed. Those increases would be considerable given the significant number and cost of transmission projects that would be assigned to SW Transco according to the confidential response to Staff DR 13-01. See Confidential Exhibit WBM-Supp-1.

Whether rates must increase regardless of whether SW Transco is formed is a legal question which has been briefed.

If rates are increased due to the formation of SW Transco and that increase would not otherwise occur, then we come to the questions raised by the Commission, whether the transaction provides benefits to the public notwithstanding the potential for increased rates.

Q Is there any additional information that you would like to add on whether SWEPCO and SW Transco must both offer the same FERC-based rates under SPP?

A In addition to Empire and OG&E in Arkansas, I have learned that Southwestern Public Service in Texas, a subsidiary of Xcel Energy and an SPP member, also receives retail rate treatment for its transmission assets, notwithstanding its membership in SPP.

Q **Aside from return on equity and depreciation rates, are there any other reasons why SW Transco's rates could be higher than SWEPCO's for the same projects?**

A Yes. The SPP formula rate includes costs that the Arkansas PSC does not allow in rates including 100% of stock-based compensation, 100% of cash incentive compensation, and executive perquisites (except personal use of corporate aircraft). To the extent that these items are allocated from parent corporations, service corporations, or the holding company to SW Transco, Arkansas ratepayers will pay them for SW Transco, when they will not pay them for SWEPCO under current regulatory practice. Exhibit WBM-Supp-2 contains the responses to AG Data Request 7, which demonstrates this point.

Second, in addition to the return on equity and the depreciation rate, which were discussed in my original testimony, there is another critical way in which the SW Transco rate differs from retail rates allowed by the Arkansas Commission.

Q **Will you respond to several of Ms. Barton's points?**

A Yes. Ms. Barton's seven points collapse into two or three arguments.

The first is simply that having AEP involved in the transmission system will benefit Arkansas ratepayers because AEP is experienced, low cost and provides good service. But AEP would be involved both through SWEPCO and through SW Transco: "There will be no change in the planning or operation of the transmission system since the services provided to SW Transco will be through the same service providers and will be administered in the same manner that these services are being provided today to SWEPCO."[1] AEP's involvement, in and of itself—with no change in planning or operation regardless of whether the transmission is spun off—means that there is no clear benefit from the transaction, unless certain projects would be developed otherwise by third parties.

[1] Supplemental Testimony of Robert W. Bradish (December 3, 2012), p. 5.

The other issue then is one of financial wherewithal. Will the formation of SW Transco enable necessary work to be done that would otherwise remain undone (or to a lesser extent might be contracted to a third party)? The context for this claim is an estimated $450 million of investments required in transmission projects[2] which allegedly place potential hardships on SWEPCO.

Company witnesses Mr. Cogan and Ms. McCellon-Allen identify a small benefit in financing costs – a 15-basis point difference between the costs of AEP Transco debt and SWEPCO debt.[3] But this difference, while real, is trivial as compared to the increase in the cost of equity and associated income taxes that would result by using the SPP formula rates instead of SWEPCO retail rates.

Q Do you agree that SWEPCO will be financially unable to make these investments without SW Transco?

A No. SWEPCO could retain its current credit quality through 2015, while making the portion of those transmission investments that would be made by 2015, with only a modest change to the dividend policy stated in its financial projections[4]—all in the absence of SW Transco.

Furthermore and more importantly, any modest reduction in dividends paid by SWEPCO to the parent company that may occur as a result of increased transmission investment would have no true cash flow effect on the parent when compared to the same hypothetical investments that SW Transco would also need to make. This is because the dividend savings that the parent would accrue from SWEPCO if SWEPCO was no longer responsible for transmission would simply be recycled back to the SWEPCO service area as equity for the start-up of SW Transco. In other words, the equity that SW Transco would require to build transmission needs to come from somewhere because it is a zero-sum game. AEP

[2] Supplemental Testimony of Venita McCellon-Allen, December 3, 2012, p. 11.

[3] *Id.*, pp. 7-8.

[4] Based on documents that SWEPCO provided to STAFF.

would supply that equity—in the amount of the dividend increase that it would recuperate from SWEPCO's investment reduction—to SW Transco.

The details are confidential but are summarized below and detailed in Confidential Exhibit WBM-Supp-4.

Q Is there commentary from rating agencies regarding SWEPCO's financial metrics and ratings filed recently in this docket?

A Yes. I reviewed Staff DR 15-01, which contains the latest evaluations of SWEPCO (in 2009) presented by Standard and Poors (S&P). (Exhibit WBM-Supp-2) S&P essentially showed that there were large amounts of judgment in its ratings and that a downgrade could occur if "SWEPCO's financial metrics continue to evidence a sustained decline." Identified causes of such a decline would be a reduction in cash flow to debt ratios below 10% or problems bringing the Turk plant into service. Although the plant is not in regulated service in Arkansas, it is generating electricity and providing service to other SWEPCO jurisdictions. An upgrade was viewed as unlikely without an increase in the cash flow to debt percentage to the mid-teens.

The document also shows the financial metrics on which S&P bases its ratings, and shows that the ranges of these financial metrics for specific ratings are quite wide and subjective.

The three major financial metrics that S&P used were:

1 Ratio of Funds from Operations (the sum of net income, depreciation and deferred taxes and other minor items plus interest) to interest payments. This is similar to an interest coverage ratio.

2 Funds from Operations as a percentage of debt (as adjusted by S&P for leases and similar items), and

3 Debt (as adjusted by S&P) and equity as a percentage of total capitalization.

Q Did SWEPCO conduct any analysis comparing itself to the S&P metrics?

A Yes. In response to Staff DR 15-02, SWEPCO submitted confidential financial projections with and without SW Transco for the years 2012-2015 that purported to show deteriorating financial ratios if SW Transco's projects had to be built by SWEPCO.

SWEPCO's analysis purports to show rising amounts of debt from 2012-2015, which in turn causes interest payments to rise. The end result is a reduction in all three of the S&P ratios.

I include SWEPCO's response to this data request as Confidential Exhibit WBM-SR-3.

Q Was this analysis correct?

A No. SWEPCO made a number of assumptions in this model that are questionable. The model including SW Transco projects built by SWEPCO was constructed as a "short cut" rather than a full balance sheet and income statement showing all the differences in the two cases.

Without divulging confidential numbers, substantive problems with the SWEPCO analysis include the extent to which SWEPCO investments that would otherwise be made by SW Transco are funded with equity versus debt, modeling of depreciation and deferred income taxes on those investments (which affect both FFO and the amount of financing required), and dividend payouts and payout ratios from SWEPCO to the parent company.

Confidential Exhibit WBM-SR-4 contains a description of these issues, along with a revision of the model that I prepared.

Q Can you summarize the effects of your analysis and revisions at a high level?

A Financing the SW Transco projects under SWEPCO with 45-50% equity would yield financial metrics very similar to the metrics for SWEPCO assuming that the

Transco is formed. The major difference would be that the amount of dividend payments made by SWEPCO to its parent company would be reduced.

In essence, SWEPCO claims to be unable to finance transmission investments without its endangering credit quality only because SWEPCO deems that maintaining dividend payouts to AEP is more important than maintaining a balanced utility capital structure. If dividend payouts to AEP were cut by a range of [redacted] range, SWEPCO could finance its transmission in 2013-15 while maintaining its credit metrics. The financial exigency is not real, at least through 2015 – unless AEP insists on demanding high dividend payments that would impinge on SWEPCO's ability to finance transmission projects.

Q But wouldn't reducing dividends paid to AEP have financial consequences detrimental to AEP?

A Not necessarily. The money retained in SWEPCO, used to build transmission, and not paid to AEP in my alternative scenario is effectively money that AEP would have had to use to provide equity capital for SW Transco. Since SW Transco is a start-up, it would need the same amount of equity capital contributed from the parent company to have a balanced capital structure as SWEPCO would need to retain to support transmission investments with a balanced capital structure before paying dividends to the parent company.

In other words, regardless of whether SW Transco exists or not, cash raised at SWEPCO will pay for SWEPCO service area transmission in the near term, and SWEPCO will have the same credit metrics. The only question is that of corporate structure, not financial feasibility. The issue is whether SWEPCO's transmission will be funded by SWEPCO internally with lower dividends to the holding company. In the alternative, if SW Transco is set up, SWEPCO could pay higher dividends to AEP, but those dividends would be used by AEP to fund <u>the same SWEPCO projects</u> – only with SW Transco as the owner. SWEPCO would end up with similar credit metrics <u>in either case</u>.

Q So what is your ultimate conclusion, Mr. Marcus?

A At least in the near term (which includes [redacted] of SWEPCO's estimated $450 million of transmission investment), the issue is not about financial capability. SWEPCO could maintain a balanced capital structure, while paying fewer dividends to its parent company, or SWEPCO could maintain the same balanced capital structure, pay more dividends to its parent company, and have its parent company use the extra dividends to provide equity to SW Transco to finance the identical projects. There is no difference and no crisis.

As a result, I believe that this round of testimony confirms my initial findings. The Company has not shown that SW Transco has significant enough financial advantages over SWEPCO **if** SWEPCO would provide lower rates to retail customers than SW Transco could (as Empire, OG&E, and SPS do now). Financial advantages of SW Transco (including marginally lower debt costs) do not overcome the higher rates. If, on the other hand, Arkansas ratepayers are forced to pay the SPP Open Access Transmission Tariff (OATT) regardless of whether SWEPCO or SW Transco owns specific transmission equipment, then SW Transco may provide a small incremental financial benefit, as I stated before.

SWEPCO has not provided a showing of significant benefit from SW Transco if SWEPCO's retail rates would be lower, so the Commission should therefore dismiss or reject the application.

Q Does this complete your testimony, Mr. Marcus?

A Yes.

Confidential Exhibit WBM-Supp-1 Omitted

Exhibit WBM-Supp-2

SWEPCO Response to AG DR 7

BEFORE THE
ARKANSAS PUBLIC SERVICE COMMISSION

IN THE MATTER OF THE APPLICATION OF AEP SOUTHWESTERN TRANSMISSION COMPANY, INC. FOR RECOGNITION AS A PUBLIC UTILITY WITH POWERS OF EMINENT DOMAIN AND CERTIFICATED FOR THE PUBLIC CONVENIENCE AND NECESSITY TO OWN AND OPERATE TRANSMISSION FACILITIES IN THE STATE OF ARKANSAS AND THE APPLICATION OF SOUTHWESTERN ELECTRIC POWER COMPANY TO TRANSFER CERTAIN SPECIFIED CECPN AUTHORITY AND RESPONSIBILITIES TO AEP SOUTHWESTERN TRANSMISSION COMPANY, INC.	**)**	**DOCKET NO. 11-050-U**

JOINT RESPONSE OF AEP SOUTHWESTERN TRANSMISSION COMPANY INC. AND SOUTHWESTERN ELECTRIC POWER COMPANY TO ATTORNEY GENERAL'S SEVENTH SET OF DATA REQUESTS

Comes now AEP Southwestern Transmission Company, Inc. (SW Transco) and Southwestern Electric Power Company (SWEPCO) and for their Join Response to Attorney General's (AG) Seventh Set[1] of Data Requests state:

AG Data Request No. 7-1

6-1) Please provide an explanation of how Administrative and General ("A&G") spending from holding company or service company affiliates are directly assigned to or allocated among operating companies currently, and how it would change if SW Transco is authorized.

SW Transco and SWEPCO Response No. 7-1

All costs for services provided by AEP's service company (AEPSC), including administrative and general services, are directly assigned or allocated to affiliates based upon a work order accounting system. All AEPSC transactions are coded with work orders that provide instructions on how the cost for each service provided is to be distributed to affiliate companies. Specifically, each work order contains a "benefiting location" code,

[1] The data requests actually received were numbered 6-1, 6-2, and 6-3. It is believed this was a typographical error and so the responses will be shown as 7-1, 7-2 and 7-3.

which provides a listing of the affiliate, or affiliates, who benefit from each service provided. Each work order also contains an "allocation factor" code, which provides the appropriate method for allocating cost when a service is provided for the benefit of more than one affiliate. The combination of benefiting location and allocation factor work in tandem to ensure that only the affiliate or affiliates benefiting from each service are charged for the cost of the service and that the sharing of cost, when applicable, is based upon the most representative allocation methodology for the service provided.

This methodology would not change with the approval of the SW Transco. As with all other affiliates, SW Transco would be added to all appropriate benefiting locations, based upon their need for services. In addition, any new benefiting locations needed for services provided directly to SW Transco would be established. Also, statistical information related to SW Transco would be added to all applicable allocation factors. In this manner, SW Transco would receive direct charges and allocated charges based upon their consumption of AEPSC services, just like all other affiliates.

AG Data Request No. 7-2

6-2) Please describe how (a) stock-based compensation; (b) cash incentive compensation; (c) severance (d) relocation; (e) perquisites including but not limited to personal use of company aircraft, tax gross-ups on other benefits, and executive financial planning services are treated in the development of formula-based rates for SPP. To what extent are each of these items included or excluded if included in A&G expenses.

SW Transco and SWEPCO Response No. 7-2

In the development of transmission formula-based rates under the SPP Open Access Transmission Tariff, expense items (a) through (e) detailed in the question above are treated no differently than other costs incurred in the provision of service. To the extent these costs are recorded to FERC accounts that are recoverable within the formula rate, the costs are fully included within the formula rate development for both SWEPCO and SW Transco. All A&G expenses are recoverable at 100% in the formula rate calculation with the exception of FERC accounts 924, 928, 930.1 and 930.2 (see response to AG-7-3).

Both (a) stock-based compensation and (b) annual incentive compensation (or cash incentive compensation) are accrued as a loading on labor costs and recorded to the same FERC accounts as the labor costs. A portion of the labor costs, and related incentive compensation accrual, would be recorded to A&G accounts, such as FERC account 920 (A&G salaries), and would be included in the formula rate calculation.

Costs related to (c) severance are accrued to generation, transmission, and distribution O&M accounts as well as A&G account 920.

Costs related to (d) relocation are recorded to FERC accounts on a case by case basis based upon the proper accounting for each individual being relocated.

Costs related to (e) perquisites are coded based upon the type of perquisite. Any personal use of company aircraft is recorded below-the-line and not included in any formula rate calculation. Tax gross-ups are non-cash transactions that generally don't involve a company expense that could be included in the calculation of formula rates. However, tax gross-ups related to financial planning services do have an underlying expense related to payment to the firm providing the financial planning services, and those expenses are included in an A&G FERC account that is included in the calculation of formula rate

AG Data Request No. 7-3

6-3) Please describe how dues and donations allocated to SW Transco from the head office or from SWEPCO would be treated the development of formula-based rates for SPP if included in A&G expenses. Are any specific costs removed in the formula rate process?

SW Transco and SWEPCO Response No. 7-3

Any costs related to dues and donations allocated to SW Transco from AEPSC or SWEPCO and included within A&G expenses would be included in the development of formula-based rates for the SW Transco in the SPP unless charged to the following A&G accounts that are excluded from formula rates:

924 Property Insurance
928 Regulatory Commission Expense
930.1 General Advertising Expenses
930.2 Misc. General Expenses

Donations are primarily coded to a below-the-line account and would not be included in any A&G costs. Professional dues, such as those for CPA's and professional engineers, are coded to a variety of FERC accounts, including some A&G accounts that are included in the development of formula rates. Company memberships, including chambers of commerce and economic development organizations, are primarily coded to A&G account 930.2 which, as described above, is excluded from the development of formula rates.

Additionally, per FERC Docket No. ER10-355-000 dated September 24, 2010, any formation costs for SW Transco that have been incurred after June 30, 2010, are non-recoverable through the SW Transco formula rate. Formation costs are booked to both O&M and A&G accounts and are specifically identified and would be excluded from the SW Transco formula rate calculation.

Respectfully submitted,

MATTHEWS, CAMPBELL, RHOADS
McCLURE & THOMPSON, P. A.
119 South Second Street
Rogers, Arkansas 72756
(479) 636-0875

By: /s/ David R. Matthews
David R. Matthews (76072)

Attorneys for AEP Southwestern Transmission Company, Inc. and Southwestern Electric Power Company

CERTIFICATE OF SERVICE

I, David R. Matthews, attorney for SW Transco and SWEPCO, certify that an electronic copy of the above document has been sent to all parties of record this 18th day of April, 2013.

/s/ David R. Matthews
David R. Matthews

Confidential Exhibit WBM-Supp-3 Omitted

Confidential Exhibit WBM-Supp-4 Omitted

CERTIFICATE OF SERVICE

I, Emon O. Mahony, do hereby certify that on this 3rd day of May, 2013, I provided a copy of the above and foregoing testimony to all parties of record by electronic mail.

/s/ Emon O. Mahony
Emon O. Mahony