

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)
FACILITIES IN THE STATE OF ARKANSAS AND)
THE APPLICATION OF SOUTHWESTERN)
ELECTIC POWER COMPANY TO TRANSFER)
CERTAIN SPECIFIED CECPN AUTHORITY)
AND RESPONSIBILITIES OF AEP)
SOUTHWESTERN TRANSMISSION COMPANY)
, INC.)**

DOCKET NO. 11-050-U

DIRECT TESTIMONY

OF

WILLIAM B. MARCUS

ON BEHALF OF

THE ARKANSAS ATTORNEY GENERAL

November 15, 2011

DIRECT TESTIMONY OF WILLIAM B. MARCUS

1 **I. Introduction and Summary**

2 **Q Please state your name, business affiliation and address.**

3 A I am William B. Marcus. I am Principal Economist for JBS Energy, Inc., 311 D
4 Street, West Sacramento, California 95605.

5 **Q Please provide your qualifications.**

6 A My qualifications are attached as Exhibit WBM-1. I have 33 years of experience
7 with energy utility issues. I have previously testified or made formal comments
8 before about forty federal, state, provincial, and local utility and environmental
9 regulatory bodies in the U.S. and Canada on issues including utility restructuring
10 and performance-based ratemaking, revenue requirements, resource planning, and
11 cost-of-service and rate design. I have filed testimony at this Commission on a
12 number of occasions since 1998.

13 **Q On whose behalf are you appearing?**

14 A I am appearing on behalf of the Arkansas Attorney General.

15 **Q What is the purpose of your testimony?**

16 A I review the proposal by AEP Southwestern Transmission Company (“SW
17 Transco”) and Southwestern Electric Power Company (“SWEPCO”) to establish
18 a new public utility to provide transmission service.

19 **Q Please summarize the proposals of SW Transco and SWEPCO.**

20 A The essence of the proposal in this application is that SW Transco and SWEPCO
21 are asking the Arkansas Public Service Commission (“APSC” or “Commission”) to
22 (1) recognize and designate SW Transco as a public utility in Arkansas;
23 (2) waive the Arkansas retail ratemaking provisions otherwise applicable to public
24 utilities operating in the state;¹ (3) transfer the Certificate of Environmental

¹ Barton Direct Testimony, p. 17 (lines 12-14).

1 Compatibility and Public Need (CEPCN) for the Flint Creek to Shipe Road
2 projects that the Commission approved Docket No. 10-074-U, Order No. 6, from
3 SWEPCO to SW Transco; and (4) implicitly, allow SW Transco to supplant
4 SWEPCO in making certain other future transmission system investments that
5 SWEPCO would otherwise have undertaken, in the absence of SW Transco.

6 The result of granting the proposals in this case is that AEP would gain access to
7 more favorable ratemaking treatment through a higher base ROE authorization
8 (10.7%², vs. the Arkansas retail ROE authorization of 10.25%) and an RTO
9 membership incentive adder to the ROE (0.5%),³ for a total authorized ROE of
10 11.2%. Arkansas retail customers would also be subject to a FERC depreciation
11 rate for SWEPCO (2.80%) versus the SWEPCO Arkansas jurisdictional rate of
12 2.20%. Higher depreciation expense would result in higher rates.

13 According to SW Transco's recent settled case with FERC, this ROE could
14 increase up to a maximum ROE of 12.45%,⁴ with an initial capital structure that is
15 more heavily weighted to equity (51.60%/48.24%, equity to debt, vs. the
16 Arkansas-authorized 45.93%/53.91%),⁵ but which could see the equity capital
17 percentage rise to as high as 52.50% for a structure of 52.50%/47.34%,⁶ and it
18 could also allow the addition of Construction Work in Progress ("CWIP") to rate
19 base. (The difference in ratemaking authorizations listed in the previous
20 paragraph are presented in tabular form in Figure 1, further down in this
21 testimony, for easier comparison.)

22 The more favorable ratemaking made possible by the formation of SW Transco is
23 the crux of this case.

24

² Exhibit RLP-3, p. 6, para. D.1.a.

³ *Id.*

⁴ *Id.* para. D.1.b.

⁵ There is 0.16% preferred stock in each of the capital structures.

⁶ Exhibit RLP-3, p. 8 para. D.2.a.

1 **Q Please summarize your recommendation.**

2 A The Commission should dismiss this case without prejudice, so as not to pre-
3 judge—at least in part—SWEPCO’s apparent intent to get a 38% increase in its
4 transmission rates. SWEPCO’s proposal will significantly raise the cost of
5 transmission to ratepayers in return for a possible slight edge in financing some
6 years in the future. Decisions involving SWEPCO’s rates should be made in the
7 next general rate case (“GRC”)

8 Essentially, SWEPCO is filing this case under the assumption that it will be
9 granted Federal Energy Regulatory Commission (“FERC”) Formula rates under
10 the Open Access Transmission Tariff (“OATT”) issued by the Southwest Power
11 Pool (“SPP”) recovered through a Commission Transmission Rider. But
12 SWEPCO will not officially request this and other favorable rate treatment until
13 SWEPCO’s next general rate case. Such a request was not granted in both
14 previous cases involving a Transmission Rider issued to date (Oklahoma Gas and
15 Electric Company in Docket No. 10-067-U and Empire District Electric Company
16 in Docket No. 10-052-U). This case essentially prejudices that SWEPCO’s
17 request will be granted, as the SW Transco can only be compensated through the
18 OATT. The case could be refiled, if warranted, after the APSC decides the issue
19 of the transmission rider for SWEPCO in SWEPCO’s upcoming rate case.

20 **Q What is the key aim of this application for SW Transco and SWEPCO?**

21 A The key aim of this application for SWEPCO and SW Transco is to provide
22 earnings growth for their parent, American Electric Power (AEP) Company. This
23 is not the AG’s claim, but AEP’s. AEP states unequivocally in its own literature:

24 *Our transmission strategy is a key component of our future earnings*
25 *growth.*⁷

26 This case is but a part of an integrated strategy, which includes:

27 *Mid-Term Investment – Seven wholly-owned transcos allow for*
28 *expansion and growth within AEP’s existing utility footprint through*

⁷ aepsustainability.com/ourissues/energy/TransmissionGrowth.aspx.

1 *an efficient recovery mechanism. Will spend \$210 million in 2011 and*
2 *more than \$350 million in 2012. ROE is in the 11.20%-11.49% range.⁸*

3 **Q Does this application have anything to do with transmission planning and/or**
4 **operations?**

5 Not at all. The request made in this application is entirely financial, and has
6 nothing to do with transmission planning and/or operations. The Company itself
7 testifies to this:

8 *The AEP transmission system will continue to be planned by AEP*
9 *Transmission and SPP in a manner that is consistent with the approved*
10 *regional planning processes in place today. Consistent with such RTO*
11 *processes and procedures, AEPTransmission will develop, propose and*
12 *construct system expansion and modification plans, and conduct system*
13 *studies in order to reliably serve customer needs. Since AEP internal*
14 *transmission planning, monitoring, and cost control measures will*
15 *continue much the same as today, the external interactions and*
16 *established communications with SPP will also continue much the same*
17 *as today. We anticipate that this communication will change for the*
18 *better as SPP implements the Integrated Transmission Planning (ITP)*
19 *process.⁹*

20 The Applicants also state:

21 *AEPTransmission will participate on behalf of SW Transco in SPP's*
22 *open, transparent planning process, just as AEPTransmission does*
23 *today on behalf of SWEPCO...¹⁰*

24 On the other side of the coin, SWEPCO will continue to operate and maintain the
25 transmission system in its service territory, including that owned by SW Transco:

26 *Exhibit LMB-4 is the service agreement for SWEPCO to provide services*
27 *to SW Transco that include, but are not limited to: consultation,*
28 *analysis, advice, and performance of services in connection with the*
29 *operation, inspection, maintenance, and emergency restoration of SW*
30 *Transco's assets in the State of Arkansas. The agreement between SW*
31 *Transco and SWEPCO also contains a provision appointing SWEPCO*
32 *as SW Transco's agent for purposes of licensing space on SW Transco*

⁸ American Electric Power, Barclay's Capital CEO Energy-Power Conference Handout, New York, NY, September 8, 2011, p. 25.

⁹ Barton Direct Testimony, p. 18 (lines 7-16).

¹⁰ *Id.* p. 19 (lines 17-19).

1 *facilities for third party joint use attachments, as well as a mutual*
2 *facilities and property license grant.*¹¹

3 In other words, any claim that this change is needed to streamline operations or to
4 provide for better transmission coordination is incorrect. Indeed, SW Transco
5 will not even have any employees, and will rely solely on AEP and SWEPCO
6 employees. Therefore the Commission's decision in this matter depends not on
7 planning and operational factors, but on the merits of the Company's assertions
8 about its financial position and the impact that this application will have on that
9 position, the impact that the proposal will have on consumers, and the precedent
10 that an affirmative decision in this case will set on the future of this Commission's
11 ability to regulate the utilities doing business in its jurisdictional territory.

12 **Q Does this application provide a clear delineation between ownership of**
13 **projects by SWEPCO and SW Transco?**

14 A No. While Ms. Barton's Exhibit LMB-5 provides project selection guidelines,
15 they have few bright lines, other than that routine capital maintenance or
16 replacement of existing SWEPCO equipment is SWEPCO's responsibility (except
17 possibly for major extra high voltage equipment), and that a project has to exceed
18 \$500,000 for SW Transco to own it. While it appears to be expected that SW
19 Transco will own major new facilities, what SW Transco will own is still subject
20 to interpretation, and it is also SW Transco's choice.

21 **Q If the application is approved, would it give the Commission adequate**
22 **authority to regulate SW Transco and SWEPCO?**

23 A Not without conditions. Much of the lack of clarity between SWEPCO and SW
24 Transco needs to be resolved if SW Transco becomes a utility, and the
25 Commission's oversight must be maintained. If this application were to be
26 approved, the Commission should adopt regulatory conditions that would:

- 27 1. Retain SWEPCO's obligation to plan and build to serve its Arkansas retail
28 load. SW Transco may own some projects, but SWEPCO would have the

¹¹ Barton Direct Testimony, pp. 15-16.

1 ultimate responsibility to assure that there is adequate transmission to
2 serve its load, and does not delegate that responsibility to SW Transco.

3 2. Require SW Transco to be subject to other aspects of Arkansas PSC
4 authority including:

5 a. Require that all of SW Transco's books and records be available to the
6 Commission.

7 b. Require that SW Transco be formally subject to the PSC's authority
8 regarding integrated resource planning, although such planning would be
9 conducted jointly with SWEPCO.

10 c. Require that the Commission must approve whether specific new projects
11 are owned by SW Transco or SWEPCO, including the ability to require
12 either SWEPCO or SW Transco to build a project depending on financial
13 and economic circumstances.

14 d. Require that any future transfers of property from SWEPCO to SW
15 Transco be made at cost with transfers in excess of \$1 million requiring
16 Commission approval.

17 **II. Ratemaking and the Relationship of this Case to Transmission**
18 **Rider Proposals**

19 **Q Are Applicants requesting a change in ratemaking for transmission owned**
20 **by SWEPCO (as opposed to SW Transco) within the SPP, in this docket?**

21 A No.

22 **Q Will SWEPCO request a change in the ratemaking treatment for SWEPCO-**
23 **owned transmission within the SPP in its next GRC?**

24 A Yes. According to Ms. Bennett's Direct Testimony and discussions between the
25 AG and SWEPCO and AEP on November 7, 2011, SWEPCO will ask the
26 Commission to approve a transmission cost rider in its next GRC, which will
27 include recovery of the OATT at the FERC formula rate to cover all SWEPCO
28 transmission costs.

29 *SWEPCO anticipates proposing a SPP-OATT transmission cost*
30 *recovery rider in its next Arkansas base rate case. A transmission cost*

1 *recovery rider of the nature described in Order No. 6 in Docket No. 09-*
2 *074-U will facilitate more efficient cost recovery for the utility, greater*
3 *transparency of the costs to be recovered and, likely, more timely and*
4 *frequent APSC review.¹²*

5 The FERC formula rate, which is the rate under which SW Transco would collect
6 revenue from Arkansas retail customers if this application is approved, includes
7 the FERC ROE of 11.2% and would include SPP-wide depreciation rates, which
8 would increase the depreciation rate from 2.2%, currently used for SWEPCO in
9 Arkansas, to 2.8%, which is the FERC approved, SPP-wide depreciation rate.¹³

10 **Q What is the effect on ratepayers of moving from Arkansas PSC to FERC**
11 **jurisdictional rate setting for both SWEPCO and Southwest Transco?**

12 A In addition to allowing higher rates of return and higher depreciation rates, the
13 OATT spreads the cost of new projects over 300 kV across the entire SPP system,
14 while spreading the cost of smaller projects and existing projects to zones.
15 SWEPCO projects are in a zone that includes two AEP subsidiaries: SWEPCO
16 itself and Public Service Company of Oklahoma (PSO). We cannot say exactly
17 what the impacts would be, but the table below (extracted from Ms. Bennett’s
18 direct testimony) is exemplary.

19 The table shows that the Applicants expect both affiliates to collect FERC OATT
20 rates at the full FERC approved formula rates, regardless of whether SWEPCO or
21 SW Transco makes the investment. Ms. Bennett in this table, attempted to show
22 that the effects of SW Transco would be limited, because its first project would
23 “only” increase costs by \$209,000 for Arkansas ratepayers, but the table actually
24 tells a different story. The cost of the SWEPCO OATT and SW Transco funding
25 are very similar, but they are 38.4% higher than the current costs under state
26 jurisdiction on an ongoing basis.¹⁴

¹² Bennett Direct Testimony, p. 14 (lines 7-11).

¹³ The issue of the depreciation rate was discussed by Ms. Bennett of SWEPCO in the November 7, 2011 conversation between the AG and the Company.

¹⁴ In addition, there are one-time formation costs for SW Transco that equal about 0.4% of state jurisdictional rates for four years.

1 **Figure 1: Table 2 from Ms. Bennett's Direct Testimony on P. 16; Illustration of the Impact**
 2 **of Investment on SWEPCO's Retail Customers**

1 **Table 2: Impact of Investment on SWEPCO's Retail Customers**

CASE NO.	1 FERC OATT		2	3 RETAIL
	SWEPCO	SW Transco		SWEPCO
INCREMENTAL REVENUE REQUIREMENT CALCULATIONS	Incremental Addition in Plant In Service	44,575,000	44,575,000	44,575,000
	ROE	11.20%	11.20%	10.25%
	Preferred Stock Rate	4.87%	4.87%	4.87%
	LTD Rate	6.00%	6.00%	6.02%
	Equity % Cap Structure	51.60%	51.60%	45.93%
	Preferred Stock Cap Structure %	0.16%	0.16%	0.16%
	Debt % Cap Structure	48.24%	48.24%	53.91%
	Cost of Capital (%)	8.68%	8.68%	7.96%
	Cost of Capital (\$)	3,869,730	3,869,730	3,548,525
	O&M	1,560,125	1,560,125	1,560,125
	Formation Costs (years 1-4 only)		26,786	
	Depreciation Rate	2.8%	2.8%	2.2%
	Depreciation Expense	1,234,728	1,234,728	976,193
	FIT	1,387,119	1,387,119	1,129,862
	State/Local Tax	286,231	286,231	233,146
	Incremental Revenue Requirement	8,337,933	8,364,719	7,447,851
OATT ALLOCATION	x Zonal Load Share (SPP Zone 1)	38.5%	38.5%	
	Equals Incremental OATT Trans Expense	3,210,104	3,220,417	
3rd Party Rev Credits	Less 3rd Party Revenue Credits			(5,127,829)
	Net Retail Trans Rev Requirement			2,320,022
NET ARKANSAS IMPACT	x Jurisdictional Load Share	23.2%	23.2%	23.2%
	Equals AR Jurisdictional Allocation of Incremental Revenue Reqmnt	745,996	748,393	539,150

2

3

1 **Q Have the Applicants claimed that the higher equity returns contained in this**
2 **proposal are consistent with Commission policy?**

3 A Yes, but the claim rings hollow. SWEPCO states, “This incremental return would
4 also seem consistent with the APSC’s recent expression in its January 11, 2011,
5 Order in Docket No. 10-041-U of support for improvement of the transmission
6 system in Arkansas.”¹⁵

7 The Attorney General reminds SWEPCO and the Commission that Docket No.
8 10-041-U is merely an application by Plains and Eastern Clean Line LLC, or
9 “Clean Line,” for approval of a Certificate of Convenience and Necessity (CCN)
10 to operate as a public utility in the Arkansas. The Commission expressed support
11 for “the development of transmission infrastructure in the state of Arkansas as
12 well as the development of opportunities to use and transmit renewable power for
13 the benefit of Arkansas utilities and their ratepayers.”¹⁶ But this bare statement is
14 hardly an endorsement of increased rates of return, and this application will have
15 no effect on transmission planning or operations.

16 **Q Is this OATT transmission rider rate proposal at issue in this case?**

17 A Not specifically, as SWEPCO has stated that it will not request it until the next
18 rate case.

19 However, the decision on the OATT rate rider is critical for making a reasoned
20 decision in this case, even though SWEPCO has scheduled the discussion of that
21 rider several years after it is asking for this approval.

22 If SWEPCO gets a 38% rate increase for all of its transmission projects, then the
23 choice between having and not having SW Transco is a secondary choice. There
24 may be some financing benefits arising from the Transco discussed below that
25 could mean that the increase will be somewhat less than 38% in later years. But if
26 the choice is between adopting SWEPCO’s proposed transmission rider and

¹⁵ Bennett Direct Testimony, p. 17 (lines 6-8).

¹⁶ Docket No. 10-041-U, Order No. 9, p. 9.

1 another form of the rider, then SW Transco becomes a source of the rate increase,
2 not the source of potential minor mitigation of rate increases.

3 **Q Will you provide some further context on the OATT transmission rider?**

4 A SWEPCO seems to be assuming, almost as a matter of course, that the
5 Commission will approve its proposal for the OATT transmission rider for its
6 entire transmission system, including the greater amount of equity in the capital
7 structure, 11.2% ROE, and higher depreciation rates. By making that
8 assumption, SWEPCO is claiming that the decision to establish SW Transco
9 would have very little impact.

10 **Q Is it the Commission's policy to allow Commission to allow integrated,**
11 **Arkansas-jurisdictional utilities to charge their retail customers at the full**
12 **FERC OATT for direct transmission investments?**

13 A Not necessarily. The language in Order No. 6 from 09-074-U does not
14 unambiguously support such a position. Order No. 6 from 09-074-U states:

15 *[t]he Commission supports the implementation of a transmission rider*
16 *for the recovery of costs associated with regionally-allocated transmission*
17 *costs for SPP RTO members if such a rider includes mechanisms that*
18 *fairly balance the interests of Arkansas's jurisdictional SPP members*
19 *and their customers.¹⁷*

20 The transmission rider adopted by the Commission, in Docket No. 10-052-U, for
21 Empire, does not provide for Empire to flow through its OATT to Arkansas
22 customers. Empire filed a GRC application in Docket No. 10-052-U in which it
23 requested a transmission cost rider, but it was related to actual OATT charges
24 from the SPP, not to direct transmission investments by Empire. This point is
25 confirmed by the following statement from Staff witness, Elana Davis, in that
26 proceeding:

¹⁷ Docket 09-074-U Order No. 6, p. 24.

1 *Empire's proposed rider will only include the costs associated with*
2 *regional SPP charges. Empire will continue to recover its direct*
3 *transmission investment and operating costs through its base rates.*¹⁸

4 The Empire case was settled, but the settlement followed Staff's position on the
5 rider, including only two Schedules from the SPP tariff, for scheduling and other
6 ancillary services (Schedule 1) and for costs of new transmission spread over all
7 SPP customers (Schedule 11). The settlement also assured that Arkansas
8 ratepayers would continue to receive benefits from point-to-point transmission
9 revenues and from additional off-system sales generated by Empire's
10 membership in SPP.

11 Similarly, in Docket No. 10-067-U OG&E only asked for the Commission to
12 authorize the transmission rider to:

13 *(i) recover payments made to SPP for the revenue requirement related to*
14 *transmission plant owned and operated by third parties of which OG&E*
15 *has been regionally allocated a portion of the costs; (ii) recover OG&E's*
16 *SPP Administrative Fee; and (iii) credit customers for point to point*
17 *transmission revenue and revenue credits associated with sponsored*
18 *transmission upgrades.*¹⁹

19 Again, there was no request to use the OATT to calculate rates for OG&E's retail
20 loads.

21 As a result, it appears to me that there is a serious question of whether SWEPCO
22 would actually be granted the 38% rate increase for all of its transmission costs
23 under the OATT tariff, including the 11.20% ROE, despite SWEPCO's claims to
24 the contrary.

25 **Q Has this Commission in the past supported transmission ratemaking policy**
26 **contrary to granting SWEPCO a FERC OATT collected through a Rider?**

27 A Yes. FERC requested comments on FERC's Notice of Inquiry (NOI) regarding
28 Promoting Transmission Investment Through Pricing Reform, to which the
29 Arkansas Commission submitted comments in concert with state utility

¹⁸Direct Testimony of Elana Davis, Docket No. 10-052-U, p. 5 (lines 17-19).

¹⁹ Direct Testimony of Donald R. Rowlett in Docket No. 10-067-U, p. 16.

1 commissioners from agencies in Kansas, Missouri, Nebraska, New Mexico,
2 Oklahoma, and Texas, as members of the Southwest Power Pool Regional State
3 Committee (“SPP RSC”). These comments are included as Exhibit WBM-2. In
4 this NOI, FERC requested comments regarding (1) the factors that FERC should
5 evaluate an application for incentives; (2) the obstacles faced by transmission
6 developers and what incentives are best suited to addressing those obstacles;
7 (3) the way the FERC should consider changes in cost estimates; and (4) any
8 other factors that FERC should consider in implementing the law.

9 Among other comments and recommendations, the SPP RSC provided the
10 following in response to FERC’s request:

11 *The SPP RSC recommends no ROE Incentives for the formation of*
12 *transmission-only companies, or Transcos, but should the [Federal*
13 *Energy Regulatory] Commission grant such incentives, they should be*
14 *limited to Independent Transcos. This prevents the formation of utility-*
15 *affiliate Transcos for the sole purpose of earning a higher ROE.²⁰*

16 This SWEPCO proposal, to create SW Transco and be a utility-affiliated Transco,
17 would seem to be precisely the type of restructuring that the SPP RSC is correctly
18 intent on preventing.

19 **Q Does SWEPCO’s intention to recover its direct transmission investments**
20 **under OATT rates impact how the Commission should deal with this case?**

21 **A** Yes. SWEPCO seems to be filing its cases in the wrong order. SWEPCO has
22 reserved the fundamental policy issue of whether it should get a 38% increase in
23 its transmission rates through OATT and the rider for its next rate case. It is
24 asking for approval of SW Transco, which can only be dealt with through the
25 OATT and rider process because it does not serve load, thereby partially
26 prejudging the answer to that question.

²⁰ Comments of the Southwestern Power Pool Regional State Committee in FERC Docket No. RM11-26-000, served in a letter from the APSC, September 1, 2011, p. 6.

1 It would be more reasonable to determine how to treat SWEPCO's direct
2 transmission investment before deciding whether this form of corporate
3 organization should be approved.

4 If the Commission were to decide to give SWEPCO OATT rates, including an
5 11.20% rate of return, on all of its directly-invested transmission, then the
6 creation of SW Transco for incremental transmission investment would not make
7 much difference, and may even be slightly advantageous to ratepayers. However,
8 if the Commission were to deny OATT rates in SWEPCO's upcoming GRC
9 transmission rate rider request, then the adoption of the requests to provide SW
10 Transco a CECPN and incremental transmission investment obligations would
11 clearly harm ratepayers and should be denied.

12 Therefore, the Commission should dismiss this case without prejudice. It could
13 be refiled, if warranted, after the APSC decides the issue of the transmission rider
14 for SWEPCO in SWEPCO's upcoming rate case.

15 The remainder of this testimony will analyze SWEPCO's rationale for the
16 creation of SW Transco.

17 **III. SWEPCO's Claimed Transco Benefits**

18 **A. *Alleged Improvements to SWEPCO's Financial Condition***

19 **Q What are the Applicants' main arguments supporting this proposal?**

20 A The Applicants state that recent and future capital spending for generation,
21 distribution and transmission, in addition to, future spending on environmental
22 upgrades, has forced SWEPCO to "very carefully monitor its cash flows and cash
23 metrics in order to maintain an investment grade debt rating and plan for any
24 needed additional debt or equity."²¹ The applicants conclude, "It is in the best
25 interest of SWEPCO and its customers to explore additional sources of financing

²¹ Bennett Direct Testimony, p. 7-8 (starting with line 22).

1 that will help keep SWEPCO’s customers rates as low as possible. SWEPCO
2 believes that SW Transco is part of that solution.”²²

3 **Q Do the Applicants allege that they are making this proposal as a result of and**
4 **to prevent further credit rating downgrades?**

5 A Yes. The Applicants indicate that SWEPCO is concerned about SWEPCO’s debt
6 rating, indicating Moody’s downgraded SWEPCO’s senior unsecured debt to
7 Baa3—one notch above non-investment-grade debt—on July 6, 2009, and that if
8 the company were to fall below the investment-grade level procuring capital
9 would be “even more expensive.”

10 **Q Have the AEP Companies made similar arguments in other states to support**
11 **stand-alone Transco utilities?**

12 A Yes. As noted, AEP has formed seven transcos, including SW Transco. Each of
13 those that have filed applications before their respective state regulatory body has
14 made some form of the following argument:

15 *Vertically-integrated investor-owned utilities are facing a*
16 *challenging and uncertain environment. [OpCo X] is facing*
17 *significant pressure to maintain its credit ratings while, on the*
18 *other hand, its capital spending needs are significant across all*
19 *areas of its utility business, including transmission, and are*
20 *projected to extend over the next decade. If these transmission*
21 *system additions were constructed and financed through debt*
22 *issued by [OpCo X], that increased debt burden could adversely*
23 *affect its financial condition and credit profile. On the other hand,*
24 *financing this needed investment using [Transco Y] will not*
25 *adversely affect the financial condition and credit rating metrics of*
26 *[OpCo X].*²³

²² *Id.* at p. 8 (lines 1-4).

²³ This example comes from pp. 3-4 (starting at Line 16) of Mr. Boteler’s Direct Testimony in Case No. PUE-2010-00038 for Appalachian Power Company and AEP Appalachian Transmission Company, Inc. before the Virginia State Corporation Commission (docket.scc.state.va.us/CyberDocs/Libraries/Default_Library/Common/frameviewdsp.asp?doc=100979&lib=CASEWEBP%5FLIB&mimetype=application%2Fpdf&rendition=native). Mr. Boteler makes similar statements in his direct testimonies in the following cases before various state regulatory bodies: Case No. 44000 (Indiana Michigan Transco) before the Indiana Utility Regulatory Commission (myweb.in.gov/IURC/eds/Modules/Ecms/Cases/Docketed_Cases/ViewDocument.aspx?DocID=0900b6318015ce78), pp. 3-4 (starting at Line 17); Case No. 2011-00042 (Kentucky Transco) before the Kentucky

1 In every case where state regulators require AEP's transcos to file an application,
2 AEP companies have filed testimony that AEP operating affiliates require a
3 separate Transco to reduce their financial stress. It is not just SWEPCO. The
4 highly generic nature of this testimony filed by AEP does not give confidence as
5 to the extent or nature of either the potential burden that AEP's integrated utilities
6 are facing or benefits to ratepayers, particularly since AEP is still the source of
7 equity capital for all of the Transco deals and must provide debt financing to the
8 Transcos until they have mature assets that can become more self-financing.

9 **Q Has SWEPCO actually been downgraded?**

10 A Yes. As the Applicants state, Moody's downgraded SWEPCO to BBB minus in
11 2009.

12 **Q Does the rating downgrade by Moody's shed any light on the nature of AEP
13 and SWEPCO's financial and business risk?**

14 A Yes. SWEPCO and SW Transco conveniently left out the reason for the
15 downgrade:

16 *The rating downgrade primarily reflects the continued weakness in*
17 *SWEPCO's balance sheet and overall financial profile as well as*
18 *the materially higher business and operating risk profile*
19 *associated with the construction of a new coal-fired generation*
20 *facility (Turk Plant).²⁴*

21 In fact, a Moody's Senior Vice President (Jim Hempstead) said the following:

Public Service Commission (psc.ky.gov/pscscf/2011%20cases/2011-00042/20110207_AEP_Kentucky_Transmission_Application.pdf), p. 8; Case Nos. 10-245-EL-UNC, 10-246-EL-UNC, and 10-247-EL-AIS (Ohio Transco) before the Public Utilities Commission of Ohio (dis.puc.state.oh.us/TiffToPdf/A1001001A10C02A92347E90665.pdf), p. 6; Case No. 10-0577-E-PC (West Virginia Transco) before the West Virginia Public Service Commission (www.psc.state.wv.us/scripts/WebDocket/ViewDocument.cfm?CaseActivityID=294878&NotType='WebDocket'), p. 5 (lines 8-16). Mr. Joshua D. Burkholder made similar statements on p. 7 (lines 8-21) of his Direct Testimony Case No. U-32058 (SW Transco) before the Louisiana Public Service Commission (lpscstar.louisiana.gov/star/ViewFile.aspx?Id=69140a5f-5388-466f-b3dc-c60fc0117c07); Case No. 10-0577-E-PC (, p. 5 (lines 8-16). In some cases (SWEPCO and Indiana Michigan Power Company in Indiana), there is added commentary that the pressure on credit-worthiness threatens to take both of those companies into non-investment-grade ratings territory.

²⁴ Moody's Investor Services, July 2009. "Moody's downgrades Southwestern Electric Power Company to Baa3 senior unsecured; outlook stable." SWEPCO provided this document in Staff DR 5-1.

1 *The regulatory, environmental and execution risks associated with the*
2 *Turk Plant create a materially higher business and operating risk profile*
3 *for SWEPCO and this elevated risk profile is expected to be accompanied*
4 *by much weaker financial metrics over the next few years.*²⁵

5 Mr. Hempstead continued, stating:

6 *While legal challenges related to coal-fired construction are not that*
7 *unusual in this sector, the current environmental momentum appears to*
8 *be heightening these risks, and SWEPCO's decision to proceed with*
9 *construction will create continual exposure to these risks over the*
10 *intermediate-term horizon.*²⁶ (Emphasis added.)

11 Moody's continues, stating:

12 *An unusually high amount of risk is associated with constructing the*
13 *Turk plant, and is incorporated into the Baa3 rating. These risks include*
14 *the numerous legal and regulatory challenges currently facing the Turk*
15 *plant's Arkansas Certificate of Environmental Compatibility and Public*
16 *Need (CECPN), the air permit, the PUCT's conditional permit, wetlands*
17 *preservation efforts and requests for regulatory recovery of financing*
18 *costs on construction work in progress (i.e., CWIP).*²⁷

19 These statements indicate that the Moody's downgrade of SWEPCO was related
20 to the Turk installation. While a further downgrade might increase SWEPCO's
21 financing costs, the reason for the initial downgrade had little or nothing to do
22 with past or future expenditure for distribution, transmission, and/or
23 generation, other than the Turk facility issue. Transmission spending is not large
24 compared to Turk and to potential generation environmental retrofits, whose
25 costs are not yet known, so that even if a future downgrade were to occur, it is
26 unlikely that it could be prevented by offloading transmission spending to SW
27 Transco.

28 **Q What are the opinions of other ratings agencies with respect to SWEPCO**
29 **business and financial risk?**

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

1 A Both Standard and Poor’s (S&P) and Fitch provide ratings on SWEPCO. Neither
2 has downgraded SWEPCO’s credit rating since SWEPCO proposed the Turk
3 facility.

4 S&P considers SWEPCO's business risk profile excellent and its financial risk
5 profile aggressive, and does not even mention Turk in its December 2009 ratings
6 issuance. The only reason S&P mentions Turk in its most-recent rating issuance is
7 as an example of how, “although the diversity in markets and in regulation
8 somewhat elevates credit quality,...managing the complex variety of regulatory
9 environments can be challenging and requires constant vigilance.”²⁸

10 **Q Do ratings agencies consider SWEPCO’s affiliation with AEP when assessing**
11 **SWEPCO’s risk?**

12 A Yes. S&P states, simply:

13 *Standard & Poor’s Ratings Services bases its ratings on Southwestern*
14 *Electric Power Co. (SWEPCO) on the consolidated credit profile of its*
15 *parent, American Electric Power Co. Inc. (AEP), which includes*
16 *regulated and unregulated operations.*²⁹

17 As S&P considers AEP’s business-risk profile to be excellent, the ratings agency
18 considers SWEPCO’s business-risk profile to be excellent. As S&P considers
19 AEP’s financial-risk profile to be aggressive, the ratings agency considers
20 SWEPCO’s financial-risk profile to be aggressive, stating the following:

21 *SWEPCO's financial risk profile reflects AEP's consolidated financial*
22 *risk profile, which is considered as aggressive. This includes a large*
23 *capital spending program and financial measures inline for the rating.*
24 *The company's considerable capital expenditures are needed to fund its*
25 *environmental-compliance programs for stricter air-quality standards*
26 *and for new generation and transmission.*³⁰

²⁸ Standard and Poor’s Research, June 9, 2011. “Summary: Southwestern Electric Power Co.” SWEPCO provided this document in Staff DR 5-1.

²⁹ Standard and Poor’s Research, December 16, 2010. “Summary: Southwestern Electric Power Co.” SWEPCO provided this document in Staff DR 5-1

³⁰ *Id.*

1 Even SWEPCO's liquidity is dependent on and managed by AEP, according to
2 S&P. And in S&P's view, AEP's liquidity is adequate.

3 The implication from S&P is that it is not SWEPCO as a stand-alone operation
4 with which the ratings agency is concerned. As such, SWEPCO should not be
5 concerned with how SWEPCO's incremental transmission might affect its credit
6 quality, as it is the overall AEP operation and investments with which S&P is
7 concerned. Additionally, it is not clear that SW Transco will get a better rating
8 from S&P than SWEPCO if both are tied to the parent, AEP.

9 **Q Even if SWEPCO were to be downgraded to a double-B rating, are the**
10 **higher rates resulting from SW Transco cost-effective?**

11 A The Applicants have presented no evidence comparing the cost of a downgrade
12 versus the cost of FERC Formula rates for SW Transco. As noted above, if a
13 downgrade were to occur, it would likely occur regardless of whether the
14 Commission goes forward with SW Transco or not. The near-term assets that
15 could be funded by SW Transco instead of SWEPCO are limited compared to the
16 much larger investments in Turk and potential investments in future generation
17 environmental retrofits.

18 **B. *SWEPCO and SW Transco's Access to Capital Markets***

19 **Q How is SW Transco proposed to be funded?**

20 A SW Transco is proposed to be funded through its own debt—although it will be
21 dependent on the parent for debt financing in the near future until it achieves
22 sufficient assets and revenues to support independent access to debt markets. Its
23 equity funding will be provided through AEP. SW Transco will also participate
24 in the overall AEP Money Pool for short-term financing, if—as we expect—it is
25 treated like other AEP subsidiaries including transcos.³¹

³¹ Direct Testimony of Mr. Boteler (p. 7, lines 7-14) in Case No. 2011-00042 before the Kentucky Public Service Commission. The citation states: "The operation of the Money Pool is designed to match, on a daily basis, the available cash and borrowing requirements of each participant, thereby minimizing the need for borrowings from external sources. In order to obtain the benefits enjoyed by the Company and its

1 The equity funding source is largely the same for both SW Transmission and
2 SWEPCO. SW Transco will actually be more dependent on AEP for equity
3 funding in the near term, because SWEPCO has some retained earnings that will
4 also provide it with equity that SW Transco will not have until it has operational
5 projects.

6 **Q Then how does SWEPCO allegedly benefit from the creation of SW**
7 **Transco?**

8 A SWEPCO and SW Transco indicate more than once that a transition of the
9 responsibility to construct transmission in SWEPCO's service territory from
10 SWEPCO to SW Transco will free SWEPCO's capital resources to focus on
11 needs other than transmission.³² The Companies also indicate that it is not
12 "practical" for SWEPCO to continue to rely on AEP financing to support its
13 capital requirements.³³

14 The problem with SWEPCO and SW Transco's logic is that regardless of
15 changing the box in which transmission is constructed—whether under SWEPCO
16 or SW Transco—the company that finances transmission will require capital. SW
17 Transco, particularly as a start-up with no asset base, will rely on AEP's financial
18 resources, even though it is allegedly not "practical" for SWEPCO to do so. In
19 Mr. Boteler's words:

20 *In the same manner that SW Transco will rely on AEPSC and AEP*
21 *Transmission for operational/technical and managerial resources, SW*
22 *Transco will also be able to initially rely on the financial resources of its*
23 *ultimate parent, AEP, and its ability to supply, or cause to be supplied,*
24 *capital. As evidenced in its 2010 annual report, AEP had revenues,*
25 *assets, and common shareholders' equity of over \$14 billion, \$50 billion,*
26 *and \$13 billion, respectively. AEP, as a parent corporation, has the*
27 *ability to draw on the full range of available market financial resources to*

affiliates on the AEP System, the amendment will allow KY Transco to participate in the AEP Utility Money Pool along with the existing participants and the other AEP Transcos. Except for the addition of KY Transco and the other new participants, the terms and conditions applicable to the operation of the AEP Utility Money Pool will be unchanged."

³² Barton Direct Testimony, pp. 9-10, Bennett Direct Testimony, pp. 7-9, and 19.

³³ Boteler Direct Testimony, p. 8.

1 *obtain the necessary capital to meet its obligations, including the initial*
2 *support of SW Transco.*³⁴

3 Mr. Boteler also testified in Kentucky that AEP makes equity contributions to
4 subsidiaries as a matter of normal practice, even though it is not “practical” in
5 Arkansas.

6 *Throughout AEP’s history, AEP has repeatedly shown a willingness to*
7 *support its subsidiaries with contributions of equity and/or debt capital*
8 *as needed. As recently as 2009, AEP contributed \$1.14 billion of equity*
9 *capital to its subsidiaries to support credit quality and help subsidiaries*
10 *meet their financial obligations.*³⁵

11 **C. *The Investor Perspective on Separate Transcos***

12 **Q Is separation of transmission plant from the integrated utility preferable in**
13 **the eyes of debt or equity investors?**

14 A AEP commissioned a white paper to assess AEP’s decision to form transcos of
15 the nature referenced in this application, whose objectives are to support new
16 transmission development, with the aid of a series of interviews the author
17 conducted with investors and credit rating agencies. AEP included the white
18 paper, called, *AEP Transco: The Investor’s Perspective*, in its Kentucky-based
19 transco’s application for recognition as a utility by the Kentucky Public Service
20 Commission of Kentucky (Kentucky PSC)³⁶ SWEPCO provided the document to
21 the AG in an email, dated November 7, 2011.

22 I have attached the full white paper as Exhibit WBM-3 to my testimony

23 **Q What is the ultimate finding stated in the white paper?**

24 A The author of the white paper, Ms. Julie Cannell makes the following statement:

25 *Investors have embraced the notion of the new Transco. In their view,*
26 *the entity provides the vehicle for showcasing an appealing business and*

³⁴ Boteler Direct Testimony, p. 7-8 (starting at line 22).

³⁵ Case No. 2011-00042 before the Kentucky PSC. Direct Testimony of Mr. Boteler, p. 4-5 (starting at line 19), submitted February 4, 2011.

³⁶ Case No. 2011-00042 before the Kentucky PSC. Exhibit 2, attached to the Direct Testimony of Mr. Boteler, submitted February 4, 2011.

1 *will provide a clear, direct way to invest in it. Importantly, the Transco*
2 *is not considered to pose a deterrent to the credit quality or risk levels of*
3 *existing AEP entities. In short, this new company is viewed as a positive*
4 *move for AEP and its subsidiaries.*³⁷

5 **Q Please comment on AEP Transco: The Investor’s Perspective in the context of**
6 **this case.**

7 A The AG does not take exception to the main finding of the document—that a
8 block of investors is interested in investing in pure-play transmission companies
9 under the type of regulation provided by FERC today, even though we also
10 recognize that some investors and rating agencies continue to look at AEP as a
11 whole rather than at its parts. But that finding also raises some questions as to:

- 12 1. Whether AEP only wants to invest equity where it can get a high return
13 and low risk, and
- 14 2. Whether the OATT method of setting transmission rates for both
15 SWEPCO and SW Transco is in the public interest.

16 **Q Why are those questions raised?**

17 A We need to briefly examine the business risk that transmission companies face
18 under the OATT model and compare them to the rewards to understand the
19 attractions of “pure play” transmission. Several aspects of business risk are
20 discussed below.

21 Major transmission assets have regulatory and construction risk as they are being
22 conceived and built (regulatory risk, risk of siting, cost overruns, and eminent
23 domain, and for large projects that may take several years to complete, a
24 financing risk if the project is not included in rates until the project comes into
25 service). They face these risks, regardless of whether they are built under an
26 integrated utility or under a separate transco.

³⁷ Julie M. Cannell, *AEP Transco: The Investor’s Perspective*, p. 3.

1 However, there are significant risk reductions arising from the FERC Formula and
2 the OATT model, which SWEPCO proposes to apply to itself and which must be
3 applied to its transco, if approved. The transmission facility owner receives lump
4 sum payments from the SPP. There is virtually no counterparty credit risk and no
5 risk that the payment will come up short as a result of, for example, reductions in
6 demand for electricity. This is a significant risk reduction relative to an integrated
7 utility whose base rate revenue is dependent on demand.

8 For SWEPCO, and SW Transco by extension, the FERC formula rates also
9 provide for rates to be reset annually, which reduces risk, with projections of
10 capital spending and rate base that are trued up to actual spending levels, which
11 further reduces risk. Little maintenance capital spending would be needed on
12 relatively new transmission facilities such as those that would be built by SW
13 Transco. The only significant operational risks for in-service projects are thus
14 keeping operating and maintenance expenses at reasonable levels in order to earn
15 the authorized rate of return.

16 There are other potential, if less tangible risk reductions arising from the creation
17 of SW Transco. For example, the Applicants submit that state, transmission-only
18 subsidiaries will be “straightforward, transparent business[es], meaning that
19 investors should be able to more easily assess its operations and operating results
20 for investment purposes.”³⁸ They claim that the “transparency comes from
21 managing one type of electrical asset as opposed to operating three types of major
22 electrical assets...regulated by multiple state and federal agencies.”³⁹ I am not
23 necessarily convinced by the Companies’ discussion that transparency, by itself,
24 would be substantially greater with their proposal compared to the status quo. But
25 accepting the companies’ claim for the sake of argument, if fixed income
26 investors perceived the greater transparency as preferable, then, this factor would
27 constitute another reduction in business risk.

³⁸ Boteler Direct Testimony, p. 9 (lines 20-22).

³⁹ *Id.* pp. 9-10 (starting on line 22).

1 **Q Will you compare the business risk of the Transco to the rewards?**

2 The lower risk profile of the Transco needs to be compared to the rewards reaped
3 by the Transco. One of the reasons that the Transco, or SWEPCO on OATT,
4 would cost 38% more than SWEPCO under state regulation is because current
5 levels of FERC-regulated returns are relatively high despite the reduced risk
6 actually faced by the Transco. As Ms. Bennett notes, FERC regulation gives
7 SWEPCO, or the SW Transco by extension, a return on equity of 11.2% with a
8 52% equity and 48% debt capital structure. The return is higher even though the
9 risk that the Transco faces is greatly reduced by the SPP payment mechanism and
10 the capital project true-up.

11 Although SWEPCO has not proposed to take them at this time and SW Transco's
12 first filing will allegedly mirror SWEPCO, FERC also offers other incentives for
13 large complex projects, including the inclusion of CWIP in rate base, guaranteed
14 recovery of costs of projects that must be abandoned, which deals with the pre-
15 construction risk discussed above; and higher rates of return.

16 SWEPCO is taking a 50-basis-point incentive for belonging to a Regional
17 Transmission Organization (RTO). This incentive allegedly compensates
18 SWEPCO for giving up some control over its system, but the RTO structure also
19 creates the significant risk reduction to SW Transco, and SWEPCO if it were
20 allowed to use the OATT, which I discussed in my response to the previous
21 question. In other words, the 50-basis-point incentive authorized by FERC for
22 belonging to an RTO makes little sense; if anything, the rate of return on
23 investments made under an RTO should be lower, not higher, given the fact that
24 the risks involved are lower than they would be for investments made outside of
25 the RTO.

26 **Q Have other entities recognized the lower risk of transcos by granting lower**
27 **equity percentages and/or lower equity returns?**

28 A Yes. In Alberta, Canada, for example, there is a very similar structure to SPP.
29 The Alberta Electric System Operator ("AESO") collects money in transmission

1 rates paid by electric distribution ratepayers in Alberta and pays each transmission
2 owner a fixed amount of money every year, set in a rate case. The AESO can
3 mandate that owners build projects and must refund money to the transmission
4 owner (and collect the money from distribution ratepayers) if a mandated project
5 is cancelled by the AESO. For all AESO-mandated projects, the capital costs are
6 trued up to actual capital costs, just as with SPP. However, in its most recent
7 decision, the Alberta Utilities Commission set a rate of return on equity of 9% for
8 transmission owners (and all other wires utilities) and, in recognition of the low
9 risk associated with these projects, allows transmission owners just 36% common
10 equity.⁴⁰⁴¹

11 In another example, the Public Utilities Commission of Texas (“PUCT”) pools
12 transmission costs across all the owners in the Electricity Reliability Council of
13 Texas (“ERCOT” - which is not under FERC jurisdiction because its territory is
14 only in Texas, and does not cross state boundaries). The PUCT sets a default
15 equity percentage of 40% and a default return on equity of 10% for transmission
16 assets. Individual utilities can have slightly higher or lower rates of return.

17 **Q Is AEP planning on investing in Texas transmission infrastructure despite**
18 **the lower return and lower equity thickness?**

19 A Yes. AEP—through the Electric Transmission Texas (“ETT”), which is a 50/50
20 partnership of its transco with MidAmerican Electric Holding Company⁴²—
21 expects a capital expenditure on transmission in Texas of \$3 billion at a 9.96%
22 ROE.⁴³ This is illuminating for two reasons: 1) ETT believes that it could readily
23 raise capital for the joint venture’s \$3 billion investment despite the 9.96% ROE
24 authorization and only 40% equity at the investment grade ratings of its parent

⁴⁰ Decision 2009-216 (November 12, 2009), p. 17. A new cost of capital case for 2011 and beyond is pending and awaiting a decision.

⁴¹ The Alberta Utilities Commission does allow CWIP in rate based owing to a very aggressive construction program mandated by the provincial government (*see* Decision 2011-134 (April 13, 2011) for Atco Electric), pp. 96-107.

⁴² Mid-American Electric Holding Company is owned by Berkshire Hathaway.

⁴³ Presentation to 2011 INVESTOhio Equity Conference, September 22, 2011. Provided in response to AG DR Set 4.

1 companies;⁴⁴ and 2) AEP is willing to invest in projects as large as the one they
2 have in Texas, even with the prospect of earning “just” 9.96% on the equity it
3 invests.

4 **Q What do you conclude?**

5 A It makes sense that investors would be interested in the combination of a nearly
6 certain stream of payments after upfront capital investments are made, together
7 with the bondholder protections that arise from a higher equity return and greater
8 equity thickness than the retail utility has in Arkansas.

9 Therefore, one could reasonably expect—absent reliance by investors and rating
10 agencies on the whole of AEP rather than its individual parts—that a separate
11 transco could tend to be financed with cheaper debt than an integrated utility,
12 particularly once it has a significant pool of assets in-service to keep its
13 construction risk at manageable levels. One could also expect that a transco
14 would have a lower cost of equity capital than an integrated utility because it has
15 annual rate adjustments and is not exposed to either demand risk or the risk of
16 capital costs being different than forecast.

17 The FERC formula rate structure, the lack of demand risk, and the lack of capital
18 spending risk one-year out all make transco assets extremely attractive relative to
19 the ROE and capital structure that they are granted. The fact that AEP is willing
20 to commit \$1.5 billion in Texas—with another \$1.5 billion from its joint venture
21 partner—with a similar risk structure to FERC formula rates but with both a lower
22 equity thickness and a lower equity return proves the attractiveness of the transco
23 investments that AEP is now proposing to AEP itself and to Transco bondholders.

24 But the question then becomes: whether Arkansas should raise transmission rates
25 on the order of 38% to pay both SWEPCO and SW Transco higher rates of return
26 than are available to SWEPCO under Arkansas retail rates. Given the risk

⁴⁴ See Direct Testimony of Stephan T. Haynes for Electric Transmission Texas, LLC, September 12, 2008, Public Utilities Commission of Texas Docket 35665 available at http://interchange.puc.state.tx.us/WebApp/Interchange/Documents/37457_1_625744.pdf

1 reduction and the fact that AEP justified a \$1.5 billion investment in transmission
2 earning a lower return than that offered by the APSC in Texas, the Attorney
3 General would answer this question negatively.

4 **Q How does the SW Transco model affect the integrated utility's risk?**

5 A There are four possible effects of the Transco model on the remaining integrated
6 utility's risk.

7 The first effect relates to what the Applicants state repeatedly in their direct
8 testimony: the removal of transmission investments could reduce the financial
9 risk of the remaining integrated utility by reducing construction budgets. Those
10 analysts and commentators who consider SWEPCO as an entity separate from
11 AEP espouse this belief. Others, such as S&P, consider SWEPCO as part and
12 parcel with AEP, and, as such, would consider AEP as a whole when assessing
13 financial risk. In this view of the world, there would be no change to the financial
14 risk of AEP as a whole, and whether transmission is housed in SWEPCO or SW
15 Transco is irrelevant from a financial aggressiveness standpoint. Furthermore,
16 even if one did consider SWEPCO as an entity separate from AEP for the
17 purposes of assessing financial risk, transmission is such a small part of
18 SWEPCO's overall capital expenditure needs, when contrasted with the capital
19 needs for Turk and future environmental retrofits, that any financial risk reduction
20 resulting from the removal of transmission investments from SWEPCO would be
21 marginal.

22 The other three possible effects relate to the integrated utility's (SWEPCO's)
23 business risk.

24 First, depending on the composition of the remaining investments—generation vs.
25 distribution—and the complexity of the transmission assets that would otherwise
26 have been built by SWEPCO, the business risk faced by the integrated utility is
27 likely to increase by a small amount, because low-risk mature hard transmission
28 assets will increasingly become part of SW Transco.

1 Second, the business risk faced by the integrated utility would likely increase by a
2 small amount because its operating leverage—the amount of operating expenses
3 compared to the level of overall capital investment—would increase, because
4 operating expenses for generation and distribution are generally higher as a
5 percentage of capital spending than they are for transmission.

6 Finally, demand risks facing the integrated SWEPCO utility would be reduced
7 slightly. Under the SW Transco structure, a transmission cost rider similar to
8 OG&E and Empire would include a full recovery of the OATT for SW Transco
9 costs. Therefore, the risk that revenues would fluctuate while costs to be
10 collected are fixed (demand risk) would be less for SWEPCO because of the exact
11 recovery rider applied to SW Transco's costs that would otherwise be
12 incorporated in SWEPCO's base rates.

13 The overall impact of all of these additional effects means some of the risk
14 allegedly offloaded from SWEPCO to the SW Transco could still fall back to the
15 remainder of SWEPCO.

16 **IV. Conclusion**

17 **Q Will you provide some concluding thoughts?**

18 A SWEPCO is putting the cart before the horse. The major outstanding question is
19 whether the Commission should adopt a transmission rider based on the OATT
20 for SWEPCO or a narrower transmission rider like those adopted for Empire and
21 OG&E. While the Attorney General comes down in favor of the narrower rider,
22 this question will not be answered until SWEPCO's next general rate case.

23 Instead, in this docket, SWEPCO has proposed a corporate reorganization – that
24 will clearly raise Arkansas rates relative to the status quo. This reorganization is
25 part of a company-wide strategy at AEP to hive off new transmission into FERC
26 jurisdiction, where it earns more money for shareholders. The reorganization is
27 defended across the AEP area with generic testimony regarding financial
28 problems at all of AEP's utility affiliates including SWEPCO.

1 Even if there is a further credit rating downgrade for SWEPCO, the
2 reorganization is unlikely to prevent it because transmission is not a large part of
3 SWEPCO's future capital spending—or a large contributor to credit metrics—in
4 the first place.

5 Finally, the reasons that debt investors are likely to react favorably to the
6 reorganization is because the corporate reorganization reduces their business risk
7 on several dimensions, while maintaining extremely high equity returns that are
8 not offered by the APSC. The fact that AEP wants an 11.2% ROE on 52%
9 common equity for SW Transco, while willingly building a \$3 billion joint
10 venture project in Texas with a 9.96% ROE on 40% common equity shows the
11 extent to which risk and reward are misaligned for SW Transco. But all Arkansas
12 ratepayers might get from this would be a few basis points off the cost of debt at
13 some time in the future.

14 This corporate reorganization only makes sense in the event that an OATT-based
15 rider is adopted for SWEPCO, because the lower cost of debt in future years
16 might reduce costs, at least marginally, relative to having an OATT rider with
17 SWEPCO as the only transmission builder. But that decision is several years
18 away.

19 Therefore the Commission should reject this application without prejudice to
20 refiling in the event that the Commission were to approve SWEPCO's proposed
21 OATT rider in its next rate case.

22 **Q Does this conclude your testimony, Mr. Marcus?**

23 **A** Yes, it does. Thank you.

24

CERTIFICATE OF SERVICE

I, Emon O. Mahony, do hereby certify that on the 15th day of November, 2011, I provided a copy of the above and foregoing to the following at the indicated email address or by first class mail, postage prepaid, if no email address is indicated:

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