Comments on
Oklahoma Tax Commission Draft 2012 Capitalization Rate Study
Electric Industry

The following comments regarding the Oklahoma Tax Commission's ("OTC's") Draft 2012 Capitalization Rate Study for the Electric Industry were prepared by Duff & Phelps on behalf of Public Service Company of Oklahoma.

Capitalization Rate

Based on the methodologies reflected in the OTC's Draft 2012 Capitalization Rate Study, we believe that the 2012 capitalization rate for the overall electric industry should be at least 9.20%. The summary of this minimum weighted average cost of capital is summarized as follows:

Oklahoma Tax Commission
Weighted Average Cost of Capital - Electric Industry
Revised

	Capital Structure	Pre-Float Cost	Pre-Float Wtd. Cost	Flotation Adjustment	Total Cost	Total Wtd. Cost
Debt	41.00%	5.57%	2.28%	0.75%	5.61%	2.30%
Equity	59.00%	11.25%	6.64%	3.50%	11.66%	6.88%
			8.92%			9.18%
Say			**8.90%**			**9.20%**

Capital Structure

The OTC has reflected a capital structure of 55.50% equity and 45.50% debt in their draft study. This capital structure reflects a "weighted average" of the subject company's capital structure. However, it appears that the indicated cost of debt and the various indicators of the cost of equity are based on the respective arithmetic means of each these indicators.

The capital structure and the various indicators of the cost of debt and equity should be determined in a consistent manner. Therefore, the capital structure reflected in the OTC's rate study should be based on the arithmetic mean of the comparable company's consistent with the manner in which the various cost indicators were determined. The use of the arithmetic mean in this instance avoids the capital structure being overly influenced by the largest entities in the study. Additionally, use of the mean better reflects the typical capital structure of all guideline companies utilized.

The OTC's calculations indicate that the appropriate capital structure, based on the arithmetic mean, is 59% equity and 41% debt.

Cost of Equity

The OTC has considered a number of methodologies in the determination of the 10.25% cost of equity reflected in their draft study. Given the recent turmoil in both the equity and Treasury bond markets,[1] we believe that given the methodologies reflected in the OTC's study the CAPM-Ex Ante methodology provides the best indicator of the cost of the equity as of January 1, 2012. The use of this ex-ante methodology is also consistent with the forward looking nature of valuation.

The OTC's CAPM-Ex Ante methodology results in an indicated cost of equity of 11.25%, and we recommend that a cost of equity of at this level be utilized.

Flotation Costs

The capitalization rate developed in the OTC's study will ultimately be used in the valuation of Public Service Company of Oklahoma as of January 1, 2012. The purpose of this valuation is to determine the actual fair cash value of the company as of January 1, 2012.

Actual fair cash value means "the value or price at which a willing buyer would purchase property and a willing seller would sell property if both parties are knowledgeable about the property and its uses and if neither party is under any undue pressure to buy or sell…"

A key assumption in the determination of the actual fair cash value is that it is the value or price that would result from an actual purchase. The purchase of a company, such as Public Service Company of Oklahoma, will necessarily result in the incurrence of a number of transaction costs. One such transaction cost is the cost of issuing the equity and debt necessary to affect the assumed transaction. This type of transaction costs are typically referred to as flotation costs.

The determination of the appropriate flotation costs that should be included in the weighted average cost of capital is discussed on pages 38-40 of the Cost of Capital Study prepared by Duff & Phelps for Public Service Company of Oklahoma and previously provided to the OTC.

Note

The above comments apply to the OTC's draft Capitalization Rate Study prepared for the electric industry. As discussed during OTC Industry Days meeting on March 29, 2012, we believe that there are additional adjustments, such as further review of the guideline companies utilized and consideration of a possible size premium adjustment, that should be considered in the determination of the appropriate weighted average cost of capital for a company the size of Public Service Company of Oklahoma. However, the above comments do not specifically address these issues.

Thank you for your consideration of our comments.

[1] As discussed during the OTC Industry Days meeting on March 29, 2012.