Before

**The Public Utilities Commission of Ohio**

In the Matter of the Application of )

Columbus Southern Power Company and )

Ohio Power Company for Authority to ) Case No. 11-346-EL-SSO

Establish a Standard Service Offer ) Case No. 11-348-EL-SSO

Pursuant to §4928.143, Ohio Rev. Code, )

in the Form of an Electric Security Plan )

In the Matter of the Application of )

Columbus Southern Power Company and ) Case No. 11-349-EL-AAM

Ohio Power Company for Approval of ) Case No. 11-350-EL-AAM

Certain Accounting Authority )

**Direct Testimony of J. Edward Hess**

**on Behalf of Industrial Energy Users-Ohio**

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**May 4, 2012** **Attorneys for Industrial Energy Users-Ohio**

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**I. INTRODUCTION**

**Q1. Please state your name and business address.**

A1. J. Edward Hess, 21 East State Street, 17th Floor, Columbus, Ohio 43215

**Q2. By whom are you employed and in what position?**

A2. I am a Technical Specialist for McNees Wallace & Nurick LLC (“McNees”) providing testimony on behalf of Industrial Energy Users-Ohio (“IEU-Ohio”). IEU‑Ohio is an association of commercial and industrial customers and functions to address issues that affect the price and availability of energy they need to operate their Ohio plants and facilities.

**Q3. Please describe your educational background.**

A3. I received a Bachelors of Business Administration degree from Ohio University in 1975 majoring in accounting. I completed the majority of Capital University’s Master of Business Administration program and I have completed many regulatory training programs. I am a certified public accountant.

**Q4. Please describe your professional experience.**

A4. I have been employed by McNees since October 2009. In March 2009, I retired from the Public Utilities Commission of Ohio (“Commission”) after 30 years of employment. My last position with the Commission was as the Chief of the Accounting and Electricity Division of the Utilities Department. My duties included ensuring statutory compliance with state and federal laws, rules, regulations, and procedures governing utility regulation with the majority of that responsibility in the electric industry. I was also responsible for the operating income and rate base portions of base rates and general accounting matters in all of the utility industries.

**Q5. Have you previously testified before the Commission?**

A5. As part of my responsibilities as a Commission employee, I have provided expert testimony in numerous Commission proceedings. I began testifying in the early 1980’s. More recently I provided written testimony in Case Nos. 09-872-EL-FAC and 09‑873‑EL‑FAC, 10-2929-EL-UNC and Case Nos. 11-351-EL-AIR and 11‑352‑EL‑AIR on behalf of IEU-Ohio.

**Q6. What documents did you review before your recommendation?**

A6. I reviewed the majority of the documents in Case Nos. 99-1729-EL-ETP and 99‑1730‑EL‑ETP shortly after the case was filed. I recently reviewed the testimonies of Dr. John Landon, Dr. Edward P. Kahn, William R. Forrester, Section F of the Application, the Stipulation filed on May 5, 2000, the Staff Report filed on March 28, 2000, sections of the Opinion and Order filed on September 28, 2000 and sections of the Entry on Rehearing filed on November 21, 2000.

 I also reviewed the testimonies of Robert P. Powers, Selwyn J. Dias, Philip J. Nelson, William A. Allen, Laura J. Thomas, David M. Roush, Oliver J. Sever, Jr., Thomas E. Mitchell, Thomas L. Kirkpatrick and Frank C. Graves filed in this case, and any other document mentioned in this testimony**.**

**II. PURPOSE OF THE TESTIMONY**

**Q7. What is the purpose of your testimony?**

A7. My testimony addresses some of the problems presented by Columbus Southern Power Company’s (“CSP”) and Ohio Power Company’s (“OP”) (collectively “AEP‑Ohio”) proposal to establish a two-tiered capacity charge for purposes of setting the generation capacity price paid by competitive retail electric service (“CRES”) suppliers. I also address AEP-Ohio’s request to implement a Pool Termination Provision to recover lost revenues, and AEP-Ohio’s request to implement a non-bypassable transitional Retail Stability Rider (“RSR”) to replace lost revenues.

 Based on the advice of counsel and my reasoning from that advice, it is my opinion that AEP-Ohio’s Modified Electric Security Plan (“ESP”) request for a two-tiered capacity charge, the Pool Termination Provision and the RSR, if approved, will allow AEP-Ohio to receive additional generation service-related transition revenue well beyond the time when the receipt of such revenue is precluded by Ohio law and well after the amount and type of transition revenue eligible for recovery from customers was addressed and resolved in prior Public Utilities Commission of Ohio (“Commission”) cases associated with AEP-Ohio’s implementation of Ohio’s electric restructuring legislation enacted by the 123rd General Assembly (Amended Substitute Senate Bill 3 or “SB 3”). AEP-Ohio’s opportunity to collect transition revenue was determined as a part of AEP-Ohio’s electric transition plans (“ETP”) filed with the Commission in December 1999 as a result of the enactment of SB 3. I therefore conclude that AEP-Ohio’s proposal for establishing the generation service capacity price paid by a CRES supplier, the Pool Termination Provision and the RSR are unreasonable and, based on the advice of counsel, illegal.

**III. TRANSITION REVENUES**

**Q8. Were you involved in AEP-Ohio’s ETP filings?**

A8. Yes. As my testimony above states, I was employed by the Commission as a staff member when the plan was filed and I supervised the review of AEP-Ohio’s transition cost request.

**Q9. What is your understanding of how and when SB 3 permitted collection of transition revenue?**

A9. Like many states that enacted electric restructuring legislation in the late 1990’s, Ohio addressed the subject that was typically referred to as “stranded costs” for those services for which a customer could select a competitive supplier. This subject provoked most of the debate about how to move to a customer choice structure, while at the same time being fair to utilities that may have been negatively impacted if they were subjected to competition on day one of customer choice. SB 3 implemented customer choice on January 1, 2001. SB 3 also provided an opportunity for the surviving regulated entity, the electric distribution utility (“EDU”), to seek transition revenue associated with the previously integrated electric generation function for a period of years, but not after December 31, 2010. SB 3 contains the criteria that the Commission applied to determine how much, if any, of the transition revenue claim was eligible for recovery. When the Commission approved a transition revenue claim, it also approved transition charges that the EDU could then charge shopping customers for the period specified by the Commission. For non-shopping customers, the transition charges were embedded in the default generation supply price and were equal to the portion of the applicable default generation supply price that was not avoidable by shopping customers.

**Q10. Please explain the difference between transition revenue and transition costs.**

A10. An allowable claim for transition revenue had to be based on the positive difference between the generation-related revenue stream for generation service based on a date certain and capped price previously established by Ohio’s cost-based regulation and the generation-related revenue stream available from the application of market pricing to generation service supply. In some cases, the cost-based revenue stream was believed to be less than the market-based revenue stream, and in this instance, there would have been no allowable transition revenue claim and no “stranded costs” as a result of electric restructuring. A positive difference in these unbundled default generation supply prices created through implementation of SB 3 and market-based revenue streams was referred to as a transition cost reflecting the differences in value available to the generation business segment from two different means of establishing price. Although the use of the term “transition costs” or “stranded costs” may imply that SB 3 created a new type of generation-related costs that were accounted for as some type of transition costs or stranded costs, SB 3 did not do so.

**Q11. What is your understanding of the SB 3 criteria that were applied to determine how much, if any, transition revenue could be approved by the Commission and collected through transition charges?**

A11. It is my understanding that Section 4928.39, Revised Code, specified these criteria. These criteria were applied to determine the total amount of generation-related transition revenue that was eligible for collection through transition charges **if** an EDU submitted a claim for transition revenue. SB 3 did not require transition revenue to be addressed unless the EDU submitted a claim for transition revenue.

**Q12. Which EDUs submitted a claim for transition revenues?**

A12. All of the EDUs, including CSP and OP, submitted a claim with their ETP applications which also contained the plans by which the formerly vertically integrated electric utility would separate, either structurally or functionally, into distribution, transmission and generation business segments subject to important requirements to facilitate “customer choice” and avoid differentiation or discrimination by the EDU as a consequence of a customer’s choice of a supplier of generation service.

**Q13. More specifically, what is your understanding of the criteria that were used to determine how much, if any, of a particular transition revenue claim was eligible for collection through transition charges?**

A13. As indicated previously, it is my understanding that Section 4928.39, Revised Code, contains the criteria used to determine the total allowable transition revenue claim. A transition revenue claim was eligible for collection through transition charges if the revenue claim was limited to:

(1) Costs that were prudently incurred;

(2) Costs that were legitimate, net verifiable, and directly assignable or allocable to retail electric generation service provided to electric consumers in this state;

(3) Costs that were unrecoverable in a competitive market; and

(4) Costs that the utility would otherwise have been entitled an opportunity to recover.

All four of the criteria had to be satisfied for the transition revenue claim to be recoverable. With these criteria and the firm service nature of the default generation supply obligation of the EDU, the Commission evaluated transition revenue claims based on a comparison of the revenue produced by the EDU’s unbundled and capped default generation supply price and a revenue stream computed based on assumed market prices for the entire range of generating services and fixed and variable costs used in Ohio’s prior cost-based ratemaking system. Since generation service was the only service declared to be competitive by SB 3, the transition revenue evaluation process focused exclusively on the generation business segment.

**Q14. Was the amount of a total generation-related transition revenue claim potentially separated into different components?**

A14. Yes. The total allowable amount of any generation-related transition revenue claim was separated if a portion of that total claim was based on a claim for regulatory assets. The total transition charge resulting from any allowable transition revenue claim was also separated to show a separate regulatory asset charge. It is my understanding that SB 3 limited the Commission’s ability to make adjustments to the regulatory asset portion of an allowed transition charge and also required the regulatory asset portion of a transition charge to end no later than December 31, 2010. It is also my understanding that under SB 3, the non-regulatory asset portion of any transition charge which was associated with above-market generating plants had to end by no later than December 31, 2005 or the end of the market development period (“MDP”), whichever occurred first. Based on the advice of counsel, I also understand that Section 4928.141, Revised Code, which was added after SB 3, excluded any previously authorized allowances for transition costs with the exclusion becoming effective on and after the date the allowance was scheduled to end under the prior rate plan.

**Q15. Generally, how was the amount of generation-related transition revenue associated with above-market generating plants measured?**

A15. If an EDU wanted to make a claim for transition revenue, it had to include the claim in its proposed ETP. A proposed ETP had to be filed 90 days after the effective date of SB 3. The statutory criteria discussed above were then used to determine how much of the generation-related transition revenue claim was eligible for collection through transition charges. For the generation plant-related portion of the transition revenue claim, the Commission’s Staff used the net book value of generating assets at December 31, 2000 as the baseline to determine how much, if any, of the net, verifiable, prudently incurred book value of the EDU’s generation assets (including generation-related regulatory assets) would not be recoverable in the market. In this context, the market included the entire market, including the wholesale and retail segments.

 Various methods were used by EDUs to evaluate transition revenue claims. The most popular approach was a revenue-based approach. Generally, the revenue-based approach projected revenue streams for the various generating plants and computed a present value of the future estimated revenue streams. The present value of the estimated future revenue streams was then compared to the net book value of the generating plants at December 31, 2000. Generation plant-related transition costs were deemed to be positive (and potentially eligible for recovery through transition charges) if the present value of the projected revenue streams was, in the aggregate, less than the net book value of the generating plants at December 31, 2000. Again, the generation plant-related transition revenue had to be recovered during the period beginning January 1, 2001 through either the end of the MDP or December 31, 2005, whichever occurred first.

**IV. AEP-OHIO’S ETPs**

**Q16. Please describe the generation plant-related transition revenue claim made by CSP and OP in their proposed ETPs.**

A16. CSP and OP filed their proposed ETPs on December 30, 1999. As a part of their proposed ETPs, OP and CSP submitted a claim for transition revenue which included both above-market generation plant costs and a regulatory asset component. CSP and OP relied upon Dr. John Landon to estimate the extent to which they had a basis for claiming generation plant-related transition revenue. Dr. Landon used a revenue-based approach that I described earlier in my testimony. Dr. Landon projected market-based generation revenue, expenses and capital expenditures for the period 2001 through 2030 using multiple scenarios reflecting different assumptions about natural gas prices and environmental regulations. He discounted these projections to December 31, 2000 to develop his net present value revenue stream and then compared this net present value to net generation plant and associated asset book values as of the same date, December 31, 2000. From this comparison, he rendered an opinion on the amount of generation plant-related transition revenue that the Commission should approve for CSP and OP (the present value revenue delta or difference between a cost-based ratemaking revenue stream and a competitive market revenue stream). The results of CSP and OP’s witness Landon’s analysis are summarized on his Exhibit JHL-2 filed as a part of his direct testimony which was filed on December 30, 1999 in the AEP-Ohio ETP proceedings.[[1]](#footnote-1) His Exhibit JHL‑2 is attached to my testimony as Exhibit JEH-1. Dr. Landon updated his schedules on April 19, 2000 in the same ETP cases.

**Q17. Did Dr. Landon’s methodology for determining generation plant-related transition revenue cover the generating plants and the time period that are included in AEP-Ohio’s proposed two-tiered capacity proposal for setting the capacity price paid by a CRES supplier?**

A17. Yes. His methodology included all of the components of cost-based ratemaking including return on investments, operation and maintenance expenses, depreciation expense, taxes other than income taxes, and income taxes associated with the **total** generation service (fixed and variable costs and both wholesale and retail market segments). His analysis covered the period from 2001 through 2030.

**Q18. What were the results of his analysis?**

A18. Dr. Landon’s testimony concluded that AEP-Ohio would be unable to recover a significant amount of generation-related value in the competitive market.

**Q19. Did you rely on Dr. Landon’s analysis to make a recommendation to the Commission?**

A19. No. I have included a description of Dr. Landon’s results to describe the type of analysis that was performed to identify if an EDU had transition revenue, if so how much, and any portion that needed to be separated as a result of being associated with generation-related regulatory assets.

**Q20. Did the Commission’s Staff perform an analysis to evaluate AEP-Ohio’s transition revenue claim?**

A20. Yes. The Staff hired a consultant, Resource Data International, to assist with the evaluation of AEP-Ohio’s generation plant-related transition revenue claim.

**Q21. Did the Staff agree with the results of AEP-Ohio’s and Dr. Landon’s conclusions about the potential form of generation plant-related transition revenue?**

A21. No. The Staff took exception to AEP-Ohio’s estimate of above-market generation costs. Other parties to the ETP cases contested AEP-Ohio’s claim as well.

**Q22. How was the dispute over AEP-Ohio’s generation plant-related transition revenue claim ultimately resolved?**

A22. As part of a settlement package that was approved by the Commission, CSP and OP agreed to drop their generation plant-related transition revenue claim.[[2]](#footnote-2) The same Commission-approved settlement provided CSP and OP with the opportunity to collect a significant amount of transition charges for regulatory assets with the regulatory asset transition charges ending on December 31, 2007 for OP and December 31, 2008 for CSP. As part of this Commission-approved settlement, AEP-Ohio also committed to not “… impose any lost revenue charges (generation transition charges (GTC)) on any switching customer,” an outcome that was designed to encourage shopping.[[3]](#footnote-3)

**Q23. Was this ETP settlement contested?**

A23. Yes, Shell Energy Services Company L.L.C. (“Shell”) contested the settlement based on its claim that the generation-related regulatory asset transition revenue recommended in the settlement should have been reduced by “stranded benefits” that Shell said existed for AEP-Ohio because AEP-Ohio’s generating assets were worth more in the market than they were worth under traditional cost-based regulation.

**Q24. Did AEP-Ohio testify in support of the ETP settlement?**

A24. Yes, attached to my testimony is the prefiled AEP-Ohio testimony supporting the settlement (Exhibit‑JEH‑2) and portions of the transcript from the ETP proceedings in which the AEP-Ohio witness was cross-examined (Exhibit‑JEH‑3).

**Q25. At page 7 of AEP-Ohio witness Robert Powers’ testimony, Mr. Powers states that AEP-Ohio did not previously seek generation plant-related transition revenue. Is Mr. Power’s testimony correct?**

A25. No. As I have explained and the Commission’s records confirm, AEP-Ohio did seek such transition revenue and agreed to forego the opportunity to receive transition revenue as part of a Commission-approved ETP settlement.

**Q26. Has AEP-Ohio acknowledged that it was given an opportunity to recover above-market generation investments during the transition period created by SB 3, that the period for doing so is over, and that it gave up whatever opportunity it had to seek transition revenue?**

A26**.** Yes.  AEP-Ohio recently (March 30, 2012) filed an application with the Commission to secure approval of changes to its corporation separation plan in Commission Case No. 12-1126-EL-UNC.  As part of that application, AEP-Ohio is proposing to transfer generating assets and the application seeks a waiver from the Commission’s rule [Rule 4901:1-37-09(C)(4), Ohio Administrative Code (“O.A.C.”)] that AEP-Ohio says would otherwise require the submission of an analysis of the market value of the plants to be transferred.  At page 7 of the corporate separation application, AEP-Ohio states:

The request to waive Admin. Code Rule 4901:1-37-09(C)(4) is reasonable because OPCo seeks to transfer its generating assets to an affiliate within the same parent corporation, in compliance with the mandate of R.C. 4928.17.  Under SB 3, all of these generation assets were subjected to market and EDUs therefore were given a temporary opportunity to recover stranded generation investments during a transition period.  That transition period is over.  EDUs can no longer recover stranded generation investments, and transferring the generation assets based on an arbitrary determination of their current fair market value rather than net book value would be inappropriate.[[4]](#footnote-4)

 In addition to the period for obtaining transition revenue or “stranded costs” being over, AEP-Ohio agreed, as I identify in my testimony, to give up that opportunity as part of the Commission-approved ETP settlement discussed earlier in my testimony.  That ETP settlement was contested by one party because the party believed that AEP-Ohio had negative transition costs or “stranded benefits” and argued that the “stranded benefits” (generation plant net book values below market) should have been netted against the regulatory asset transition costs authorized for AEP-Ohio to increase the shopping credits.

 On November 6, 2000, AEP-Ohio filed a memorandum contra to the party’s application for rehearing on the settlement’s treatment of transition revenue.  Beginning at page 6 of that memorandum, AEP-Ohio stated:

Under the Stipulation neither Company will impose any generation transition charge on any switching customer. Stipulation, Section IV. The Companies original transition plan filings included GTCs calculated on the basis of a lost revenues approach.  The Commission in its Opinion and Order estimated that the claims that the Companies had foregone as a result of their agreement not to impose GTCs amounted to several hundred million dollars.  Nonetheless, Shell argues on rehearing that the Commission erred in adopting the Stipulation’s resolution of the Companies’ GTCs.

This argument illustrates perfectly the bankrupt nature of Shell’s advocacy.  Shell is relegated to arguing that the Stipulation is unreasonable because it contains a provision that eliminates all generation transition charges for both Companies. (emphasis removed)[[5]](#footnote-5)

 In the Commission’s November 21, 2000 Entry on Rehearing addressing and rejecting that party’s protest of the Commission-approved settlement, the Commission said:

The primary stipulation also addresses the netting of GTCs since AEP agreed to withdraw its claim for recovery of any GTCs set forth in its transition plans.  To the extent that there may be stranded generation plant benefits, the signatory parties to the primary stipulation have agreed that AEP’s withdrawal of GTCs reasonably offsets any possible stranded benefits.  The Commission finds this compromise to be a reasonable resolution of the netting issue raised by the language in Section 4928.39(B), Revised Code.[[6]](#footnote-6)

**V. AEP-OHIO’S TWO-TIERED CAPACITY CHARGE**

**Q27. You provided testimony in AEP-Ohio’s Case No. 10-2929-EL-UNC in which AEP-Ohio requested a “cost-based” formula to set the capacity price that is paid by a CRES supplier. In this case, AEP-Ohio is proposing a two-tiered capacity charge. Does the change from the “cost-based” formula for capacity charges to a two-tiered capacity charge change your view that AEP-Ohio is improperly seeking to recover transition revenue through its proposed capacity charge?**

A27. No. In this proceeding, AEP-Ohio is continuing to seek approval of an above-market capacity charge. Through its proposed capacity charge structure, AEP‑Ohio is seeking to collect the positive difference between the revenue received by the generation business segment for generation capacity service where such revenue is computed based on a known and measurable market-based capacity price and revenue which AEP-Ohio has computed based either on its version of a cost-based capacity formula rate charge or an arbitrary two-tiered capacity pricing structure. Regardless of the form or level of the capacity charge proposal, AEP-Ohio is persistently seeking another opportunity to collect transition revenue. The proposal which AEP-Ohio has put forward in this proceeding is designed to provide AEP-Ohio with generation-related revenue it says it will lose if customers shop and CRES suppliers pay a market-based capacity price. This is a proposal to recover lost revenue which is conceptually the same as the lost revenue claim that AEP-Ohio agreed to forego as part of the ETP settlement I describe in my testimony.

**Q28. If approved, would the proposed two-tiered formula for setting the generation service capacity price for CRES supplier’s rates allow AEP-Ohio to recover above-market generation costs?**

A28. Yes. Based on my understanding, the market-based prices for capacity are based upon PJM Interconnection LLC’s (“PJM”) Reliability Pricing Model (“RPM”). RPM relies on an auction process to secure adequate capacity resources to meet projected demand for all load serving entities (“LSEs”) that do not elect the fixed resource requirement (“FRR”) option under RPM. According to IEU-Ohio witness Kevin Murray, the clearing prices in the most recent base residual auctions for the balance of RTO zone were $110.00 per megawatt-day (“MW-day”) for the 2011-2012 delivery year, $16.46 per MW-day for the 2012-2013 delivery year, $27.73 per MW-day for the 2013-2014 delivery year and $125.94 per MW-day for the 2014-2015 delivery year.[[7]](#footnote-7) Based on Mr. Murray’s analysis of other market-based prices for capacity, I understand that the RPM capacity clearing prices are consistent with the market-based prices in bilateral transactions involving willing buyers and sellers. AEP‑Ohio’s proposed two-tiered rate would set the charge for capacity provided to CRES suppliers at $255.00 per MW-day or $146.00 per MW-day.[[8]](#footnote-8) These charges are significantly above prevailing market prices as determined by the PJM RPM process and as otherwise described in Mr. Murray’s testimony.

**Q29. Are capacity prices paid by CRES suppliers reflected in prices paid by retail customers obtaining generation supply from a CRES supplier?**

A29. To analyze this from a regulatory perspective, you have to assume that they are included. Common sense dictates that CRES suppliers will pass through known changes in the prices of the products and services they sell to retail customers unless there is competitive pressure blocking such pass-through. Since there would not be any competitive pressure under AEP-Ohio’s FRR structure, it is unreasonable to assume that CRES suppliers will choose to forego passing through the significantly above-market capacity prices to retail consumers. Additionally, American Electric Power Service Corporation (“AEPSC”), on behalf of an AEP-Ohio affiliate, stated to the Federal Energy Regulatory Commission (“FERC”) that it was AEPSC’s belief that capacity charges assessed under its proposed and so-called “cost-based” formula rate “…ultimately will be recovered from retail customers…” including retail customers served by a competitive supplier.[[9]](#footnote-9)  Contrary to the suggestions that AEP-Ohio has made throughout these proceedings, in Case No. 10-2929-EL-UNC and in public statements about the behavior of CRES suppliers, the statements made by AEPSC at FERC make it clear that it would be unreasonable to assume that the significantly above-market capacity charge that AEP-Ohio is seeking in these proceedings and elsewhere will not be passed on to retail customers.  Further, when administratively estimating market prices for purposes of conducting the market rate offer (“MRO”) versus ESP test, AEP-Ohio witnesses J. Craig Baker and Laura Thomas have both included capacity prices as a necessary component of a competitive retail market price.[[10]](#footnote-10)

**Q30. Has AEP-Ohio described its request for a two-tiered capacity charge as a transition charge?**

A30. Yes. On February 27, 2012, AEP-Ohio filed a motion seeking authorization to implement the two-tiered generation service capacity charges until the Commission resolves Case No. 10-2929-EL-UNC. In response to the Commission’s Entry on Rehearing rejecting the Stipulation on February 23, 2012, AEP-Ohio explained that it believed it had the ability to establish cost-based rates, but complained that it was being forced to move to RPM-priced capacity “without a reasonable transition mechanism” for “a transition period.”[[11]](#footnote-11) In a press release on the same day, the Chief Executive Officer of AEPSC stated, “The settlement agreement allowed AEP Ohio a reasonable transition to market over a period of time.”[[12]](#footnote-12)

AEP-Ohio previously relied upon PJM’s RPM to establish the market-based price for generation service capacity, which was approved by the Commission. In this proceeding, AEP-Ohio is proposing to change to a capacity pricing methodology that, if approved, would provide AEP‑Ohio with revenue for generation capacity service that is significantly in excess of the revenue that AEP-Ohio would be able to collect if a PJM-determined market-based price were used to determine the revenue AEP-Ohio collects for generation capacity service provided to a CRES supplier.

**VI. POOL TERMINATION PROVISION**

**Q31. Will you describe your understanding of AEP’s Pool Termination Provision?**

A31. The Pool Termination Provision is included in AEP-Ohio witness Nelson’s testimony. Mr. Nelson states that members of the AEP Pool provided written notice of their mutual desire to terminate the existing AEP Pool Agreement on three-year’s notice in accordance with Article 13.2. According to Mr. Nelson, AEPSC, on behalf of the operating companies that are members of the AEP Pool, will make a filing with FERC notifying it of the member’s intention to terminate the Pool Agreement on January 1, 2014. Mr. Nelson requests that AEP-Ohio, the EDU, be authorized to make a subsequent application with this Commission if needed to recover lost revenue related to the termination of the AEP Pool Agreement.

**Q32. Does Mr. Nelson explain what he means by lost revenues?**

A32. Mr. Nelson states that by terminating the Pool Agreement, it will require “the Company” to find new or additional revenues to recover the costs of its generating assets, or reduce the costs of those assets. He states that the capacity payments received by AEP-Ohio cannot be mitigated by opportunities in the market alone.

**Q33. Has AEP-Ohio identified that it has the legal authority to request these lost revenues?**

A33. No, and based on advice of counsel, none of the statutory provisions that define what can be included in an ESP identify an allowance for anticipated lost generation revenues resulting from termination of anything like the AEP Pool Agreement. To the extent that AEP-Ohio may be exposed to lost revenue as a result of Pool Agreement termination, the lost revenue should have been included in the request for transition revenue which I have described earlier in my testimony, a request that AEP-Ohio subsequently agreed to forego. The generation function of AEP-Ohio was separated from AEP-Ohio, the EDU, when AEP-Ohio’s ETPs became effective on January 1, 2001 and generation service became a competitive retail electric service. I would note that the corporate separation requirements established by SB 3 became effective prior to January 1, 2001. Lost generation revenues incurred after January 1, 2014 should not be recovered and I believe are not recoverable from Ohio retail customers because of the commitment made by AEP-Ohio in the ETP settlement and based on my understanding of Ohio law of what can be included in an ESP.

**Q34. Did the analysis that was performed in the ETP cases for transition revenue contemplate the use of AEP-Ohio generation assets pursuant to the AEP East Pool Agreement?**

A34. Yes. The revenue-based approach that I described earlier utilized a generation output amount for each generating unit owned by CSP and OP regardless of whether the output was for retail, wholesale or affiliated company purposes. There were no attempts to separate the generation plants between retail, wholesale, Pool or any other category.

 Further evidence that would support the conclusion that all generating output was considered is supplied by the fact that the baseline for the ETP transition revenue analysis of lost revenue relied upon the total AEP-Ohio net plant balances as of December 31, 2000. Again, there was no attempt to differentiate generation-related investment between retail, wholesale, Pool or any other category. The transition revenue claim process looked at the difference in total revenue streams associated with the use of all the generating plants.

**Q35. Do you believe that AEP-Ohio’s request to file for a Pool Termination Provision should be approved by the Commission?**

A35. No. Among other things, the Pool Termination Provision is another proposal to collect transition revenue. As I have stated before in this testimony, the complete transition revenue opportunity was evaluated in the ETP process. This evaluation included revenue erosion or lost revenue from the generating assets participating in the AEP Pool. The Pool Termination Provision is unreasonable and, based on the advice of counsel, illegal. I would also note that AEP-Ohio has not identified the regulatory process that would be part of the Pool Termination Provision. More specifically, the type of rider mechanism that is contemplated by the Pool Termination Provision typically should be accompanied by both financial and managerial audits to make sure that the rider is not used improperly to make Ohio consumers responsible for inappropriate charges or charges resulting from imprudent or unnecessary actions. Even if an ESP could include a Pool Termination Provision like that proposed by AEP-Ohio, it would be unreasonable to approve such a provision since AEP-Ohio has failed to identify the financial and managerial audit process that would attach to such a provision.

**VII. RETAIL STABILITY RIDER**

**Q36. Will you describe AEP-Ohio’s request for an RSR?**

A36. AEP-Ohio, the electric distribution company, is seeking authority to recover lost base generation revenues, lost generation revenues associated with the Environmental Investment Carrying Cost Rider (“EICCR”), lost CRES capacity revenues and the lost revenues it may experience if the proposed $3/MWh credit for shopped load is approved. This additional lost revenue recovery mechanism is the RSR which AEP-Ohio says is a transitional rider.

The RSR proposal uses 2011 revenue as a baseline and requests that the rider be sufficient to guarantee AEP-Ohio a revenue level that will produce a 10.50% return on equity. If approved, the RSR will be collected through May 2015. As with the Pool Termination Provision, AEP-Ohio has failed to identify the financial and managerial audit process that would attach to the RSR to make sure that the RSR does not turn out to be a “blank check.”

 The effect of the RSR is to provide the AEP-Ohio EDU with a guaranteed revenue stream in the event the revenue collected for default generation supply service is not equal to the targeted amount. There are no strings attached to the use of the revenue produced by this revenue guarantee mechanism, no reduction in rates to recognize the generation-related business and financial risk that this mechanism transfers to shopping and non-shopping customers and, as already noted, no identification of the financial or managerial audit process that will apply to the RSR.

**Q37. Is the proposed RSR reasonable?**

A37. No.  AEP-Ohio is proposing that this charge be applicable to all distribution customers.  This proposal is a misuse of the EDU status and responsibility as the standard service offer (“SSO”) default supplier to subsidize its separated generation function.  This proposal would charge all customers for the lost default generation-related revenue and do so without providing any benefits to customers. Like the capacity charge proposal and the Pool Termination Provision, the RSR proposal seeks to recover generation-related revenue that may not be collected otherwise. Accordingly, the proposed RSR is another improper attempt to collect transition revenue. Like the capacity charge proposal and the Pool Termination Provision, the RSR effectively and improperly rebundles AEP-Ohio’s distribution and generation functions, thereby violating corporate separation requirements that apply when an EDU is seeking to provide a competitive and non-competitive service. Therefore, I recommend that the Commission reject the RSR proposal.

If the Commission decides to accept this proposal, it should be added to the cost of the ESP proposal when comparing it to an MRO, a financial and management audit process similar to that used for the fuel adjustment clause (”FAC”) should be made part of the RSR and the return component of the RSR should be reduced to a reasonable return on long-term debt (rather than being based on a weighted average cost of capital approach) to recognize the business and financial risk that is lifted from AEP-Ohio and transferred to shopping and non-shopping customers alike. Also, since the RSR is a non-bypassable generation-related charge, governmental aggregation programs should be able to avoid the charge similar to other non-bypassable generation-related charges available through the ESP option.

**Q38. Will you briefly describe the role of the SSO as part of Ohio’s electric restructuring and adoption of a “customer choice” regulatory model?**

A38. With the enactment of SB 3, and as explained previously, the structure of the vertically integrated industry changed significantly in part, as IEU-Ohio witness Murray explains, to break the link between ownership and control of assets within such an industry structure. With regard to competitive retail electric service such as generation supply and effective January 1, 2001, the EDU was confined to the role of a default supplier to customers not receiving competitive service from a CRES supplier. This default supplier status currently allows the EDU to obtain market-based compensation for default supply through the ESP or the MRO options.

 In addition to the default supply role of an EDU, SB 3 imposed numerous requirements on an EDU to make sure that retail customers as well as CRES suppliers are not subjected to an EDU’s discretion in ways that would allow the EDU to favor its owned or controlled assets or affiliated lines of business. I do not believe that these principles and requirements can be ignored. When not ignored, these principles and requirements act as barriers to the type of proposals that AEP-Ohio is seeking in this proceeding. In 2008, Amended Substitute Senate Bill 221 (“SB 221”) altered the means by which an EDU could be compensated for its default generation supply service, but SB 221 did not change the core elements of the electric restructuring architecture contained in SB 3.

**Q39. Can the generation supply portion of an EDU’s SSO be provided by a generation supplier affiliated with the EDU?**

A39. Yes. However, there are restrictions in Ohio on how the affiliated generation service supplier may interact with the EDU. These restrictions include Ohio requirements such as the corporate separation requirements. I also understand that FERC has similar requirements that were adopted as part of FERC’s efforts to restructure the electric industry. The relationship between the affiliated generation business segment and the EDU would take the form of a wholesale transaction which I understand is subject to FERC’s jurisdiction.

**Q40. Will you explain the Ohio restrictions?**

A40. SB 3 required the vertically integrated utility companies to unbundle generation, transmission and distribution services and operate under corporate separation plans to maintain walls between competitive and non-competitive services. These separation plans were filed as a part of the ETP as required by Section 4928.17, Revised Code. The purpose of the corporate separation plan was described in the filing requirements for the ETP under Rule 4901:1-20-16(A), O.A.C.

Purpose and scope Electric utilities are required by section 4928.17 of the Revised Code, to file with the commission an application for approval of a proposed corporate separation plan. The rule provides that all the state’s electric utility companies must meet the same standards so a competitive advantage is not gained solely because of corporate affiliation. This rule should create competitive equality, preventing unfair competitive advantage and prohibiting the abuse of market power. Generally, this rule applies to the activities of the regulated utility and its transactions with its affiliates. However, to ensure compliance with this rule, examination of the books and records of other affiliates may be necessary. Compliance with paragraph (G)(4) of this rule shall begin immediately. Compliance with the remainder of this rule shall coincide with the start date of competitive retail electric service, January 1, 2001, unless extended by commission order for an electric utility pursuant to division (C) of section 4928.01 of the Revised Code.

**Q41. Did AEP-Ohio file a corporate separation plan with its ETP filings?**

A41. Yes. The plan was filed under Part B of the ETPs and was described and supported by AEP-Ohio witness William R. Forrester. As Mr. Murray explains in his testimony, the AEP-Ohio corporate separation plan left generating assets in the current OP and CSP operating companies and transferred the “wires business” to a to-be-formed regulated distribution company. AEP-Ohio’s proposed corporate separation plan was approved by the Commission as part of the ETP settlement I discussed earlier in my testimony.

**Q42. As you understand it, did SB 3 require the vertically integrated electric utilities to structurally separate the unbundled functions of the utility?**

A42. Yes. That is my understanding. However, it is also my understanding that the Commission had some ability to permit the use of functional separation until structural separation could be completed. Nonetheless, any use of functional separation still had to provide for ongoing compliance with the policy specified in Section 4928.02, Revised Code, and meet other requirements of SB 3 and the Commission’s rules.

**Q43. Has AEP-Ohio updated its corporate separation plan?**

A43. Yes. As a part of its rate stabilization plan (Case No. 04-169-EL-UNC), AEP-Ohio requested and was granted authority to continue to be functionally separated. In its first ESP plan (Case Nos. 08-917-EL-SSO, *et al*.), AEP-Ohio requested to modify the corporate separation plan to allow each company to retain its distribution and transmission assets and sell or transfer their generation assets to an affiliate. The Commission ordered the companies to file for approval of their corporate separation plan within 60 days after the effective date of the Commission’s SSO rules case.[[13]](#footnote-13) On June 1, 2009, AEP-Ohio filed its corporate separation plan (Case No. 09-464-EL-UNC). The Commission concluded in that case that AEP-Ohio has, in all material aspects, implemented their corporate separation plans in compliance with Section 4928.17, Revised Code, and the orders of the Commission and that the corporate separation plans reasonably comply with the rules set forth in Chapter 4901:1-37, O.A.C. CSP and OP were recently granted authority to merge (Case No. 10-2376-EL-UNC) and AEP-Ohio filed for full legal corporate separation and an amendment to its corporate separation plan (Case No. 12-1126-EL-UNC).

**Q44. Does AEP-Ohio have separate accounting ledgers for different functions within AEP-Ohio?**

A44. Yes. Based on information that I have reviewed over the past several years, AEP-Ohio has separate functional accounting ledgers for at least the distribution function and the generation function.

**Q45. Which functional entity within AEP-Ohio or affiliated with AEP-Ohio will receive the capacity charge, Pool Termination Provision and RSR revenue if these provisions of the Modified ESP are approved?**

A45. The revenue from these proposed ESP mechanisms will be billed and collected by AEP-Ohio acting in its capacity as an EDU. The billing and collection of this revenue, as well as the effective remitting of the revenue between functions under the AEP-Ohio umbrella, will need to be recognized on the separate distribution and generation function ledgers. AEP‑Ohio’s Modified ESP and testimony supporting the Modified ESP do not identify how the internal transactions between the unbundled functions within AEP-Ohio will be recorded for accounting purposes.

**Q46. Do you believe that AEP-Ohio’s capacity charge, Pool Termination Provision and the RSR proposal conflict with your understanding of the corporate separation requirements?**

A46. Yes. These proposals have been advanced by AEP-Ohio acting in its capacity as an EDU which must be competitively neutral relative to any customer’s choice of a generation supplier. Instead of being competitively neutral, AEP-Ohio, the EDU, is selectively advancing proposals to provide its generation business segment with financial and other benefits or preferences not available to any other supplier of generation service. Throughout this proceeding and in other cases, AEP-Ohio has often portrayed itself as competing with CRES suppliers even though AEP-Ohio, the EDU, can only provide generation supply when a customer is not served by a CRES supplier. AEP-Ohio has also asserted that the generation supply benefits of Ohio’s customer choice must be delayed to allow AEP-Ohio to adjust its latest business model. The claim that AEP-Ohio needs additional time is irreconcilably inconsistent with the somewhat unique wires-transfer corporate separation plan approved by the Commission for AEP‑Ohio. It is also my understanding that any competitive service provided by AEP‑Ohio, the EDU, must be provided through a separate entity that is not benefitted by anything that AEP-Ohio, the EDU, does with regard to the provision of non-competitive services.

When AEP-Ohio’s capacity charge, Pool Termination Provision and RSR proposals are considered in light of the role and purpose of the corporate separation requirements, I believe it is clear that the Modified ESP is essentially an attempt to bypass the corporate separation requirements for the benefit of AEP-Ohio’s generation business segment and to the disadvantage of retail customers and CRES suppliers. Thus, the blueprint used by AEP-Ohio to assemble its Modified ESP ignores the building code established by the General Assembly and the Commission’s rules. I believe that both alone and in combination the two-tiered capacity charge proposal, the Pool Termination Provision and the RSR proposal are unjust and unreasonable based on numerous grounds, including the failure to abide by the corporate separation requirements.

**Q47. If the Commission decides to accept the two-tiered capacity charge proposal, the Pool Termination Provision and the RSR, should the costs of these proposals be included as part of the Modified ESP and for purposes of conducting the ESP versus the MRO test?**

A47. Yes. As explained by Mr. Murray in more detail in his testimony, if these proposals are includable in an ESP, and I believe they are not includable, they will impose additional costs on customers and, accordingly, this additional cost should be properly recognized in the ESP versus MRO test.

**VIII. CONCLUSIONS**

**Q48. Should the Commission authorize recovery of above-market generation plant-related costs through the two-tiered capacity pricing formula or the Pool termination revenue erosion request that AEP-Ohio is now proposing?**

A48. No. AEP-Ohio’s proposals are strategically asymmetrical, unbalanced, unjust and unreasonable. The potential for generation-related lost revenue resulting from Ohio’s customer choice regulatory model was analyzed and accounted for as a part of the transition from cost-based regulation to market-based regulation in AEP-Ohio’s ETPs as required by SB 3. The amount of above-market generation plant costs recoverable by AEP-Ohio was resolved in the ETP cases by AEP-Ohio agreeing to drop its right to seek any transition revenue for above-market generation plant costs. The time for bringing a transition revenue claim to the Commission has passed. And, AEP‑Ohio also committed, in the ETP settlement, to not impose “…any lost revenue charges (generation related transition charges (GTC)) on any switching customer.”[[14]](#footnote-14) AEP-Ohio passed on the opportunity for a transition to “customer choice” unencumbered by the legacy of cost-based ratemaking as applied to generation plant and it did so as part of the settlement package approved by the Commission.

I also believe it would be unreasonable, regardless of what the law may say, to permit AEP-Ohio, the EDU, to selectively and strategically revise the methods used to establish generation service capacity prices based on its desire to use the method that produces the best revenue and earnings outcome for AEP‑Ohio’s generation business segment in a context where the method that AEP‑Ohio and the Commission previously favored is now beneficial to consumers.

Accordingly, I recommend that AEP-Ohio’s proposals for the two-tiered capacity charge and the Pool Termination Provision be rejected.

**Q49. Do you have any additional recommendations for the two-tiered capacity charge?**

A49. I recommend that the actual amount of above-market capacity charge revenue that AEP-Ohio has collected as a result of the December 14, 2011 Opinion and Order in Case Nos. 11-346-EL-SSO, *et al*. and the March 7, 2012 Entry in this proceeding be applied as an offset to regulatory asset balances that are eligible for recovery from retail consumers. The amount of the offset should include interest at the rate of interest or the carrying charge rate that AEP-Ohio is using to accumulate the regulatory asset balances. Unless this offset is made, consumers are unlikely to receive timely credit for the excessive rates that AEP‑Ohio has been allowed to collect for service provided in Ohio.

**Q50. What are your recommendations for AEP-Ohio’s proposal to charge an RSR?**

A50. I recommend that the Commission find that the proposed RSR is designed to provide AEP-Ohio’s generation business segment an unfair anti-competitive subsidy flowing from a noncompetitive retail electric SSO to a competitive retail electric service and that the RSR proposal improperly gives the generation business segment an unfair and subsidized advantage of a guaranteed minimum revenue. I recommend that the Commission reject the RSR proposal.

**Q51. Does this conclude your testimony?**

A51. Yes, for the time being. As a result of the procedural schedule in this phase of the proceeding and the timing of discovery responses by AEP-Ohio, I reserve the right to supplement my testimony based on any additional information I obtain from AEP-Ohio’s discovery responses.

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#### **CERTIFICATE OF SERVICE**

I hereby certify that a copy of the foregoing *Direct Testimony of J. Edward Hess on Behalf of Industrial Energy Users-Ohio* was served upon the following parties of record this 4th day of May, 2012, *via* electronic transmission, hand-delivery, or ordinary U.S. mail, postage prepaid.

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1. *In the Matter of the Application of Columbus Southern Power Company for Approval of an Electric Transition Plan and Application for Receipt of Transition Revenues*, Case Nos. 99-1729-EL-ETP, *et al.*, Direct Testimony of Dr. John Landon, Ex. JHL-2 at 1-4 (December 30, 1999) (hereinafter “*AEP-Ohio ETP Cases*”). [↑](#footnote-ref-1)
2. *AEP-Ohio ETP Cases*, Entry on Rehearing at 4 (November 21, 2000). “The primary stipulation also addresses the netting of GTCs since AEP agreed to withdraw its claim for recovery of any GTCs set forth in its transition plans. To the extent that there may be stranded generation plant benefits, the signatory parties to the primary stipulation have agreed that AEP’s withdrawal of GTCs reasonably offsets any possible stranded benefits. The Commission finds this compromise to be a reasonable resolution of the netting issue raised by the language in Section 4928.39(B), Revised Code.” *Id.* [↑](#footnote-ref-2)
3. *AEP-Ohio ETP Cases,* Stipulation and Recommendation at 3 (May 8, 2000). [↑](#footnote-ref-3)
4. *In the Matter of the Application of Ohio Power Company for Approval of Full Legal Corporate Separation and Amendment to Its Corporate Separation Plan*, Case No. 12‑1126‑EL‑UNC, Application at 7 (March 30, 2012). [↑](#footnote-ref-4)
5. *AEP-Ohio ETP Cases*, Columbus Southern Power Company’s and Ohio Power Company’s Memorandum Contra Shell Energy Services Company, L.L.C.’s Application for Rehearing at 6-7 (November 6, 2000). [↑](#footnote-ref-5)
6. *AEP-Ohio ETP Cases*, Entry on Rehearing at 4 (November 21, 2000). [↑](#footnote-ref-6)
7. PJM conducts incremental auctions subsequent to the base residual auction for each delivery year that typically result in a small adjustment to the final capacity price for a delivery year. [↑](#footnote-ref-7)
8. Direct Testimony of Robert P. Powers at 14 (March 30, 2012). [↑](#footnote-ref-8)
9. AEPSC made this statement in a Section 205 Application at FERC on behalf of Indiana Michigan
Power Company (“I&M”). I&M’s 205 Application contains the same formula-based rate
approach that AEP-Ohio has requested be approved for it by FERC as well as the Commission.
AEPSC Transmittal Letter Accompanying Section 205 Application on behalf of Indiana Michigan
Power Company at 6, FERC Docket ER12-1173 (February 29, 2012), available at: http://elibrary.ferc.gov/idmws/common/OpenNat.asp?fileID=12904635. [↑](#footnote-ref-9)
10. *In the Matter of the Application of Columbus Southern Power Company for Approval of an Electric Security Plan; an Amendment to its Corporate Separation Plan; and the Sale or Transfer of Certain Generating Assets*, Case Nos. 08-917-EL-SSO, *et al.*, Direct Testimony of J. Craig Baker at 13 (July 31, 2008) (hereinafter, “*AEP-Ohio ESP Cases*”); Direct Testimony of Laura J. Thomas, Ex. LJT-1 (January 27, 2011). [↑](#footnote-ref-10)
11. Ohio Power Company’s Motion for Relief and Request for Expedited Ruling at 5 (February 27, 2012). [↑](#footnote-ref-11)
12. AEP-Ohio Press Release (February 27, 2012) (viewed at https://www.aepohio.com/info/news/viewRelease.aspx?releaseID=1203). A copy of the press release is attached as Exhibit JEH-2. [↑](#footnote-ref-12)
13. *In the Matter of the Adoption of Rules for Standard Service Offer, Corporate Separation, Reasonable Arrangements, and Transmission Riders for Electric Utilities Pursuant to Sections 4928.14, 4928.17, and 4905.31, Revised Code, as amended by Amended Substitute Senate Bill No. 221* Case No. 08‑777‑EL‑ORD, Finding and Order (September 17, 2008), and Entry on Rehearing (February 11, 2009). [↑](#footnote-ref-13)
14. *AEP-Ohio ETP Cases,* Stipulation and Recommendation at 3 (May 8, 2000). [↑](#footnote-ref-14)