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BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application of Columbus Southern Power Company for Approval of its Electric Security Plan; an Amendment to its Corporate Separation Plan; and the Sale or Transfer of Certain Generating Assets.	))))))	Case No. 08-917-EL-SSO
In the Matter of the Application of Ohio Power Company for Approval of its Electric Security Plan; and an Amendment to its Corporate Separation Plan.	)))))	Case No. 08-918-EL-SSO

DIRECT TESTIMONY OF KEVIN M. MURRAY ON BEHALF OF INDUSTRIAL ENERGY USERS-OHIO

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October 31, 2008

Attorneys for Industrial Energy Users-Ohio

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DIRECT TESTIMONY OF KEVIN M. MURRAY
ON BEHALF OF INDUSTRIAL ENERGY USERS-OHIO

I. INTRODUCTION

Q1. Please state your name and business address.

A1. My name is Kevin M. Murray. My business address is 21 East State Street, 17th Floor, Columbus, Ohio 43215-4228.

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").

Q3. Please describe your educational background.

A3. I graduated from the University of Cincinnati in 1982 with a Bachelor of Science degree in Metallurgical Engineering.

Q4. Please describe your professional experience.

A4. I have been employed by McNees for 11 years where I focus on helping IEU-Ohio members address issues that affect the price and availability of utility services. I have also been active on behalf of commercial and industrial customers in the formation of regional transmission operators and the organization of regional electricity markets. I have previously served as an end use customer sector representative on the Midwest ISO ("MISO") Advisory Committee and I have been actively involved in MISO working groups that focus on various issues. Prior to joining McNees, I was employed by the law firm of Kegler, Brown, Hill & Ritter in a similar capacity. I also previously spent 12 years with The Timken Company, a specialty steel and roller bearing manufacturer. While at The Timken Company, I worked within a group that focused on meeting the electricity and natural gas requirements for facilities in the United States. I also spent several years in supervisory positions within The Timken Company's steelmaking operations.

Q5. Have you previously testified before the Public Utilities Commission of Ohio ("Commission")?

A5. I have previously submitted testimony in the Ohio Edison Company, The Cleveland Electric Illuminating Company, and The Toledo Edison Company (collectively "FirstEnergy") pending electric security plan ("ESP") proceeding at the Commission (Case No. 08-935-EL-SSO) and in FirstEnergy's proceeding (Case No. 08-936-EL-SSO) requesting approval of a market-rate option ("MRO").

I have also previously submitted testimony in the FirstEnergy electric distribution companies' rate increase cases which are pending before the Commission (Case

Nos. 07-551-EL-AIR, *et al.*). However, on February 11, 2008, a Stipulation and Recommendation supported by many of the parties in those proceedings was submitted. The Stipulation and Recommendation, if adopted, would resolve many of the contested issues in the proceedings. A provision in the Stipulation and Recommendation provides that my testimony in those proceedings will not be offered.

Q6. What is the purpose of your testimony?

A6. The purpose of my testimony is to address certain changes that are necessary to the ESP proposal of Ohio Power Company ("OPCO") and the Columbus Southern Power Company ("CSP") (collectively "AEP" or "Company") in order to make the overall plan reasonable and more favorable in the aggregate than an MRO. First, the application is largely silent on how customer-sited capabilities can be eligible to satisfy the requirements that would otherwise be met through the Standard Service Offer ("SSO"). Based on advice of counsel, it is my understanding that Amended Substitute Senate Bill 221 ("SB 221") encourages electric distribution companies ("EDUs") to rely on customer-sited capabilities to meet their advanced energy resource, energy efficiency and peak demand reduction portfolio requirements. It is my understanding that these portfolio requirements must be satisfied by an EDU regardless of whether the SSO is met through the MRO or the ESP option.

Second, AEP has proposed provider of last resort ("POLR") charges that are unreasonable.

Third, changes should be made to AEP's proposed interruptible service tariffs based upon policy objectives to require EDUs to achieve peak demand reductions.

Fourth, AEP has proposed to modify its terms and conditions of service to prohibit customer participation in PJM demand response options. This is not appropriate or reasonable.

Fifth, AEP has proposed a number of changes to its line extension policies. Line extension policies should not be addressed in this proceeding.

Finally, as part of this proceeding, modifications should be made to AEP's standby and partial service tariffs as well as the avoided cost purchase price. I discuss each of these findings in more detail in my testimony.

II. CUSTOMER-SITED CAPABILITIES

Q7. What are customer-sited alternative energy resource, demand response, energy efficiency and peak demand capabilities?

A7. It is my understanding that these customer-sited capabilities are means that an EDU may use to comply with the portfolio requirements of SB 221 beginning in 2009.

Q8. How is compliance with these requirements measured?

A8. It is my understanding that compliance is addressed in SB 221 both directly and by giving the Commission the ability to issue rules. The Commission recently issued draft rules on the portfolio requirements.

Q9. How should EDUs treat customer-sited capabilities for purposes of providing the SSO in conjunction with the MRO?

A9. It is my understanding that the portfolio requirements apply to an EDU regardless of whether the SSO is provided under the MRO or ESP approach and that SB 221 encourages the use of customer-sited capabilities to meet these requirements in both an MRO and ESP context.

Q10. Does AEP's MRO application address how customer-sited capabilities will be used to meet its portfolio obligations?

A10. No, it does not. Karen L. Sloneker recognizes in her direct testimony at page 22 that SB 221 allows committed capabilities of mercantile customers to be integrated toward an EDU's portfolio requirements. Ms. Sloneker indicates that AEP plans to work with customers and other stakeholders to explore these options.

Q11. Is the information contained in the application adequate?

A11. No, it is not. The information provided by AEP amounts to a placeholder and the details regarding how customer-sited capabilities will be relied upon have not been provided. It is my understanding that the portfolio requirements in SB 221 require compliance beginning January 1, 2009. Accordingly, I believe that it is imperative that actionable details for customer-sited projects be addressed and resolved in this proceeding.

III. PROVIDER OF LAST RESORT CHARGE

Q12. What has AEP proposed as a POLR charge?

A12. AEP is requesting to recover annually $60.9 million for OPCO and $108.2 million for CSP through a non-bypassable POLR charge. According to the testimony of J. Craig Baker, a POLR charge is appropriate due to risks faced by AEP. These risks are associated both with customers switching to a competitive retail electric supplier as well as the risk that customers may subsequently return to AEP during the three-year ESP and receive service under SSO rates. AEP quantified the estimated value of this risk by using the Black-Scholes options pricing model and a series of assumptions described in Mr. Baker's testimony. The cost of purchasing options necessary to hedge this risk was used to develop the annual POLR revenue requirements for OPCO and CSP.

Q13. Does AEP plan to buy options to hedge its perceived risk?

A13. Based upon the response to IEU-Ohio Interrogatory Set 1, Question 3, which is attached as Exhibit KMM-1 to my testimony, AEP has not made a decision regarding the purchase of any hedging or futures instrument(s) to cover the risk of the POLR obligation.

Q14. Do you agree that AEP has a POLR risk?

A14. Yes, but my opinion about the degree of risk is likely different than the assumptions used in the options valuation model.

Q15. Do you believe the Commission should approve AEP's proposed POLR charge?

A15. No, not as proposed by AEP.

Q16. Why do you recommend the Commission not approve this aspect of AEP's application?

A16. There are several reasons. First, as AEP has indicated, it has not made a decision as to whether it plans to purchase any options. Therefore, simply allowing AEP to recover costs that may never occur would not be appropriate. Second, I believe AEP has both over-estimated its risks and has overlooked lower cost options that exist to mitigate risk.

Q17. How do you believe AEP is over-estimating the risks and overlooking lower cost options to mitigate risk?

A17. AEP has assumed events that may never occur and may have a low probability of occurring. For the risk of a customer switching to a competitive supplier and then subsequently returning to AEP to be real, customer switching must actually occur. In other words, until the first customer switches, the probability of a customer returning to AEP is zero. To date, AEP has experienced minimal customer switching. Therefore, you don't need to hedge against this risk until it becomes real. Hedging this risk is analogous to buying insurance in excess of your actual needs. It is like buying homeowners insurance when you only rent.

If switching does occur, and AEP buys options, there are ways to reduce the net costs of hedging the risk. Presumably, customers might switch if market prices fell below SSO rates. To hedge the risk of a customer returning, you would buy options in sufficient volumes to cover the customer's load at a strike price equivalent to the SSO rate. Once you own the option, it has value that can be captured by exercising the option, if it is "in the money". A simple example may help to illustrate this.

Let's assume that SSO rates were $.10 per kWh but market prices fell to $.05 per kWh. A customer who consumes 10,000 kWh per month switches to a third party supplier. We can also assume that the customer got a good deal and locked in a fixed price at $.05 per kWh for the three-year term of the ESP. AEP could buy a call option for 10,000 kWh per month with a strike price of $.10 per kWh. The call option would allow AEP to exercise the option and obtain power at $.10 per kWh if the customer subsequently returned to AEP, regardless of what prevailing market prices were at that time.

Let's next assume that one year after the customer switched, market prices have risen to $.12 per kWh. Since the customer has locked in power at a lower fixed rate, it is reasonable to assume the customer will not be returning to SSO service. However, the options held by AEP are now in the money. AEP can exercise the option, acquire 10,000 kWh at $.10 per kWh, and subsequently resell the power into the market at $.12 per kWh. The $200 net gain can be used to offset the upfront cost of the option.

AEP could also take steps to mitigate these risks similar to proposals that have been made by FirstEnergy and Duke Energy Ohio. Both of these companies have included provisions in their proposed ESPs that allow the customer to waive his/her right to come back to service under SSO rates during the ESP term, after receiving service from a third party supplier, if the customer agrees he/she will only return to SSO service that is priced at a proxy for market-based rates.

For these reasons, I do not believe AEP has identified a risk hedging strategy that is either least cost or prudent.

Q18. Should the POLR charge be avoidable?

A18. My recommendation is that the POLR charge should be fully avoidable for customers who waive their right to return to service at SSO rates during the three-year ESP.

If the Commission were to approve some type of POLR charge that was not fully avoidable, it must also take steps to ensure such a charge does not create an economic barrier to customers shopping. This type of economic barrier would be created if the customer is paying his/her supplier to satisfy PJM's planning reserve requirements (through PJM's reliability pricing mechanism, or RPM), while at the same time being subject to AEP's POLR charges. Therefore, if the Commission was to approve some type of POLR charge that is not fully avoidable, customers should be given the ability to pledge the capacity resources AEP holds to satisfy PJM RPM requirements, rather than also compensating their supplier to satisfy PJM RPM requirements.

IV. INTERRUPTIBLE SERVICE TARIFFS

Q19. Has AEP proposed any changes to the interruptible service rate schedules?

A19. AEP has proposed several changes. One of the changes AEP is proposing is to increase the total interruptible power contract capacity for all customers served under OPCO's interruptible power–discretionary (IRP-D) tariff from the current level of 256 MW to 450 MW. Under CSP's IRP-D tariff, no increase to total interruptible capacity is being considered, therefore retaining the current limit of 75 MVA.

Q20. Do you believe these changes in available contract capacity are appropriate?

A20. These changes are a step in the right direction, but do not go far enough. There should be no limit on the capacity available to serve customers under interruptible rate schedules. By definition, an interruptible service is always available.

Q21. Do you have any other recommendations on interruptible service arrangements?

A21. Yes. AEP has proposed an economic development cost recovery rider. It has suggested that the rider will collect from all customers, among other things, revenues foregone from customers that commit their peak demand reduction capabilities through a reasonable arrangement towards AEP's portfolio obligation. I believe a more appropriate way to treat all interruptible service arrangements, both contract and tariff-based, is to treat the revenues received from interruptible customers as revenue credit against the overall firm service revenue requirement.

V. PJM DEMAND RESPONSE

Q22. What changes has AEP proposed in the terms and conditions section of the OPCO and CSP tariffs?

A22. AEP has proposed to modify the terms and conditions of service to expressly prohibit SSO customers from participation in PJM's demand response options. In his testimony, Mr. Roush states that AEP does not believe it is appropriate for customers receiving service at regulated, SSO rates to resell utility power through PJM. He suggests that AEP Ohio's retail customers should participate in demand response only through AEP sponsored and Commission-approved options. AEP believes that demand response in wholesale markets must be designed differently in restructured and regulated states.

Q23. Do you agree with AEP's recommendation?

A23. No. AEP's argument appears to be directed at the policies of the Federal Energy Regulatory Commission ("FERC"), which has encouraged demand response in order to make wholesale markets more efficient. It is my understanding that on October 17, 2008, FERC issued a final rulemaking in Docket Nos. RM07-19-000 and AD07-7-000 that codifies some of FERC's demand response policies. The rule requires that the wholesale markets operated by regional transmission organizations allow direct participation by demand responses resources unless the laws or regulations of the relevant retail regulatory authority do not permit retail customer participation. To maximize the efficiency of the wholesale market and help discipline prices, the Commission should continue to allow retail customers to participate in PJM's demand response options, as they do today. The language in SB 221 that gives mercantile customers a choice about whether to dedicate their customer-sited capabilities to the EDU for integration into the EDU's portfolio also suggests that mercantile customers, not the EDU, should have the right to select how and where these capabilities should be deployed.

VI. LINE EXTENSIONS

Q24. Is AEP proposing changes to its line extension policies?

A24. Yes. As discussed in the testimony of Gregory A. Earl, AEP is proposing a number of changes to its current line extension policies and charges. David M. Roush also addresses AEP's proposal to add a new rate schedule called alternative feed service. I consider the issue of alternative feed service to be a line extension policy issue.

Q25. Should the proposed changes to the line extension policies be adopted by the Commission at this time?

A25. No. The Commission recently issued proposed line extension rules in Case No. 06-653-EL-ORD. Given the present timeline for that proceeding, it is unlikely that the Commission's final rules will be issued and approved by the Joint Committee on Agency Rule Review ("JCARR") prior to the Commission's Order in this case, which I understand, on the advice of counsel, must be issued within 150 days of when the application was submitted. Until final rules have been adopted, it is not possible to determine whether AEP's proposal is consistent with the rules.

Q26. Do you have any recommendations regarding AEP's proposed alternative feed service schedule?

A26. Yes. In addition to my opinion that the issue of alternative feed service is a line extension issue, the issue has significant distribution rate implications. As AEP has acknowledged in a discovery response, which is attached to my testimony as Exhibit KMM-2, there are existing customers that presently are provided service through a redundant or second distribution feed. However, these customers do not pay a separate charge for the second distribution feed. Since the plant and facilities associated with these alternate feeds are currently in service, it is reasonable to assume that the cost is recovered through existing base distribution rates. AEP wants to grandfather the treatment of existing customers until such time as system upgrades are required, but subject any new customers requesting a second distribution feed to pay the proposed rates under the alternative feed service schedule. I would suggest that AEP's proposal to charge new customers additional money for a service it is now providing under its base distribution rates be addressed in the Company's next distribution rate case.

VII. PARTIAL SERVICE AND COGENERATION

Q27. Has AEP proposed any changes to its current partial service and cogeneration rate schedules?

A27. No.

Q28. Do you believe that the partial service and cogeneration schedules should be addressed as part of this proceeding?

A28. Absolutely. Given that cogeneration is among the customer-sited options that can fulfill the alternative energy resource portfolio obligations, it is crucial that partial service and cogeneration schedules not create barriers toward utilization of these options.

Q29. What changes should be made to the currently existing partial service and cogeneration schedules?

A29. My recommended changes are twofold. First, reservation demand charges should be dramatically reduced under the schedules to reflect a recognition that backup energy can normally be obtained from RTO power markets. Second, the avoided cost power purchased rates should be updated to reflect present day realities.

My recommendation is for AEP to provide both partial service and avoided cost purchases based upon a pass-through of energy costs reflected in hourly RTO energy markets. Under this approach, there would be no demand charge for standby, supplemental or maintenance power so long as usage is not coincident with system peak. Standby, supplemental or maintenance power would reflect a pass-through of the applicable hourly RTO locational marginal prices for energy. Avoided cost purchases would also be made at the applicable hourly RTO locational marginal prices for energy for symmetry.

VIII. RATE DESIGN

Q30. Do you have any recommendations on rate design?

A30. Yes. AEP has proposed increases in its base distribution revenues as well as its base generation (non-FAC) revenues. In both instances, AEP has proposed to collect the increased revenues by applying a uniform percentage increase to each component of base distribution and base generation rates across all rate schedules. I recognize that the Commission may authorize a different level of distribution and generation revenues in this proceeding. However, to the extent the Commission authorizes any increase in base distribution or base generation revenues, I support AEP's proposal to collect the increased revenues through a uniform increase to all components of base distribution and/or base generation rates. This is appropriate given the circumstances and nature of this proceeding. A uniform percentage increase will preserve relative revenue responsibilities between and within rate schedules and continue to recognize both fixed and variable cost elements in the rate design.

Q31. Do you have any other recommendations on rate design?

A31. Yes. It is my understanding that under certain scenarios we may not have a Commission approved ESP by January 1, 2009 that has also been accepted by AEP. If that scenario were to occur, it is my understanding that SB 221 provides that rates presently in effect will continue, subject to adjustment for any increases or decreases in fuel costs. If that scenario were to occur, I recommend that the Commission determine the total revenue increase or decrease associated with fuel costs, and divide the revenue increase or decrease by the total existing generation revenues to determine the percentage increase or decrease in required revenues. I would recommend that the percentage increase or decrease be applied on an interim basis by increasing or decreasing all components of base generation rates by a uniform percentage, subject to a cap on the total percentage increase or decrease to mitigate rate shock. I also recommend the Commission not permit any costs to be deferred during the interim period.

IX. CONCLUSION

Q32. Does this conclude your testimony?

A32. Yes, it does. However, I reserve the right to submit supplemental testimony.

Certificate Of Service

I hereby certify that a copy of the foregoing *Direct Testimony of Kevin M. Murray on Behalf of Industrial Energy Users-Ohio* was served upon the following parties of record this 31st day of October 2008, *via* electronic transmission, hand-delivery or first class mail, postage prepaid.

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Exhibit KMM-1

**AEP OHIO'S RESPONSE TO
INDUSTRIAL ENERGY USERS-OHIO'S
DISCOVERY REQUEST
FIRST SET
CASE NO. 08-917-EL-SSO & CASE NO. 08-918-EL-SSO**

INTERROGATORY REQUEST NO. 1-3

Referencing the provider of last resort ("POLR") charge annual revenue requirements of $108 million for CSP and $61 million for OP (Exhibit DMR-5), and Mr. Baker's testimony at pages 31 and 32, do the Companies intend to purchase any hedging or futures instrument(s) to cover the risk of their POLR obligation?

a. If the answer is negative, did the Companies obtain an estimate of the cost of any hedging or futures instrument(s) to meet the POLR risk, and if so, what was the cost, and why didn't the Companies reflect this option in the filing?

RESPONSE:

The Companies have not made a decision regarding the purchase of any hedging or futures instrument(s) to cover the risk of their POLR obligation. The Companies did not obtain an estimate from any third party. The Black-Scholes Model, as explained in Company witness Baker's testimony in pages 25-34, provides the best available market-based estimate of the cost for hedging the POLR obligation.

a. Not applicable

Prepared by: J. C. Baker

Exhibit KMM-2

**AEP OHIO'S RESPONSE TO
OHIO HOSPITAL ASSOCIATION'S
INTERROGATORY REQUESTS
FIRST SET
CASE NO. 08-917-EL-SSO & CASE NO. 08-918-EL-SSO**

INTERROGATORY REQUEST NO. 1-4

Please provide a narrative detailing how a customer will receive notice that the excess capacity used for no cost AFS will be used to serve revenue customers. Include details such as the point at which notice will be provided compared to the effective date of AFS Charges, how and when costs will be estimated and the process required to reserve capacity.

RESPONSE:

Existing Alternate Feed Service (AFS) customers that are currently not paying for the service will continue as "no cost" AFS customers until such time as AEP Ohio determines that distribution system capacity in the area of the AFS is projected to become deficient during the next critical load period (typically the summer cooling season). Capacity deficiency in the area means that AEP Ohio would be able to avoid a capital investment in a distribution system improvement project if it were not for the AFS capacity reservation. AEP Ohio evaluates capacity on an annual basis in the context of the next critical load period. When such capacity deficiencies are projected, the affected AFS customer is notified both verbally and in writing and is given six months notice of AEP Ohio's need to terminate the existing AFS arrangement. During the six month notice period, AEP Ohio and the customer will explore three options: discontinue alternate feed service, take partial alternate feed service at a demand level that avoids the need for system improvement (and thus avoidance of the AFS fee) or continue AFS by paying for such service under Schedule AFS. The earliest such a customer would be expected to pay for the service under Schedule AFS would be once, after the six month notice period, AEP Ohio has completed the requisite system improvements such that capacity is available. If the customer desires the AFS and system improvements cannot be completed prior to the next critical load period, AEP Ohio would work with the customer to develop an interim solution that meets the customer's needs without jeopardizing AEP Ohio facilities or service to other AEP Ohio customers.

Prepared by: D. M. Roush