BEFORE

THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Investigation into the Development of the Significantly Excessive Earnings Test Pursuant to Amended Substitute Senate Bill 221 for Electric Utilities.	))))	Case No. 09-786-EL-UNC

FINDING AND ORDER

TABLE OF CONTENTS

The Commission finds:

BACKGROUND:

On May 1, 2008, the governor signed into law Amended Substitute Senate Bill No. 221 (SB 221), amending various statutes in Title 49 of the Ohio Revised Code. Among the statutory amendments were changes to Section 4928.14, Revised Code, to establish a standard service offer (SSO). Pursuant to the amended language of Section 4928.14, Revised Code, electric utilities are required to provide consumers with an SSO, consisting of either a market-rate offer (MRO) or an electric security plan (ESP). Sections 4928.142(D)(4), 4928.143(E) and 4928.143(F), Revised Code, direct the Commission to evaluate the earnings of each electric utility's approved ESP or MRO to determine whether the plan or offer produces significantly excessive earnings for the electric utility.

After considering the arguments raised in the ESP and/or MRO proceedings of the electric utilities, the Commission concluded that the methodology for determining whether an electric utility has significantly excessive earnings as a result of an approved ESP or MRO should be examined within the framework of a workshop.[1] To carry out the Commission's directives, the Commission directed Staff to conduct a workshop to allow interested stakeholders to present concerns and to discuss and clarify issues raised by Staff. The workshop was held on October 5, 2009. Further, the Commission directed Staff to develop and file recommendations for the significantly excessive earnings test (SEET) subsequent to the workshop. Staff filed its recommendations on November 18, 2009.

By entry issued November 19, 2009, interested persons that wished to file comments were directed to do so by December 14, 2009, and to file reply comments by January 4, 2010. On December 23, 2009, a motion was filed for a five-day extension of the time to file reply comments with a request for an expedited ruling. The request for an extension of time to file reply comments was granted until January 11, 2010.

Initial comments were filed by the following interested persons: Ohio Consumers Counsel (OCC), Ohio Manufacturers' Association, Ohio Hospital Association and Ohio Energy Group (OEG) (jointly, Customer Parties); Duke Energy Ohio, Inc. (Duke); Ohio Edison Company, The Cleveland Electric Illuminating Company, and Toledo Edison Company (jointly, FirstEnergy); Columbus Southern Power Company (CSP) and Ohio Power Company (OP) (jointly, AEP-Ohio); Citizen Power, Inc. (Citizen); and Dayton Power & Light Company (DP&L). On January 11, 2010, Citizen filed a request to withdraw its initial comments in this matter and to recognize its support for the initial

---

1 *In re Ohio Edison Company, The Cleveland Electric Illuminating Company, and the Toledo Edison Company,* Case No. 08-935-EL-SSO, Opinion and Order at 64 (December 19, 2008) (FirstEnergy ESP case); and *In re Columbus Southern Power Company and Ohio Power Company,* Case No. 08-917-EL-SSO, et al., Opinion and Order at 68 (March 18, 2009) (AEP-Ohio ESP cases).

comments filed by Customer Parties. The Commission finds Citizen's request to withdraw its initial comments reasonable and the request is hereby granted. Reply comments were filed by Customer Parties (including, Citizen), Duke, FirstEnergy, AEP-Ohio, DP&L, and Ohio Partners for Affordable Energy (OPAE).

On April 1, 2010, a question and answer session was held before the Commission for interested stakeholders who filed comments or reply comments in this case. Prior to the session, 11 questions were posted to the Commission's web site for the commenters' consideration.

1. What is the legal basis for employing an earnings cap on total earnings that does not consider adjustments?

2. How should the Commission define and quantify "adjustments" that could be subject to return if the Commission found significantly excessive earnings?

3. Are adjustments which "will cause" earnings significantly in excess pursuant to Section 4928.142(D)(4), Revised Code, the same as those which "will result" in earnings significantly in excess pursuant to Sections 4928.143(E) and (F), Revised Code?

4. Does a return become "excess" as a result of "adjustments" (e.g., fuel) or as a result of the establishment of a standard service offer?

5. How should the Commission define what is significant? Is there a difference in its meaning in the various statutory sections in which it appears (Sections 4928.142(D)(4), 4928.143(E), 4928.143(F), Revised Code)?

6. What is the best way to establish the threshold for significantly excessive earnings?

7. Taking into account factors such as differences in capital requirements and business risks, should significantly excessive earnings thresholds be established on a state-wide or company-specific basis?

8. How should the Commission identify and consider "the capital requirements of future committed investments in this state"?

9. What is the mechanism that an electric utility might employ to select its proposed peer group?

10. How should the Commission treat deferrals to ensure that expenses and revenues are appropriately matched in each year and to facilitate comparisons with the reported earnings of other firms?

11. Are there any ways to apply the SEET or other steps the Commission can or should take to recognize efficient operations or discourage electric utilities from incurring inefficient or wasteful expenses to "manage" their reported earnings based on the expected results of their earnings test?

All of the commenters, and the Staff, participated in the question and answer session before the Commission.[2]

LAW:

Section 4928.142(D)(4), Revised Code, provides, in relevant part:

> The commission shall also determine how such adjustments will affect the electric distribution utility's return on common equity that may be achieved by those adjustments. The commission shall not apply its consideration of the return on common equity to reduce any adjustments authorized under this division unless the adjustments will cause the electric distribution utility to earn a return on common equity that is significantly in excess of the return on common equity that is earned by publicly traded companies, including utilities, that face comparable business and financial risk, with such adjustments for capital structure as may be appropriate. The burden of proof for demonstrating that significantly excessive earnings will not occur shall be on the electric distribution utility.
>
> Additionally, the commission may adjust the electric distribution utility's most recent standard service offer price by such just and reasonable amount that the commission determines necessary to address any emergency that threatens the utility's financial integrity or to ensure that the resulting revenue available to the utility for providing the standard service offer is not so inadequate as to result, directly or indirectly, in a taking of property without compensation

2 In addition to participating in the question and answer session, Customer Parties filed its responses to the questions on April 1, 2010.

pursuant to Section 19 of Article I, Ohio Constitution. The electric distribution utility has the burden of demonstrating that any adjustment to its most recent standard service offer price is proper in accordance with this division.

Section 4928.143(E) and (F), Revised Code, provide, in relevant part:

(E) If an electric security plan ... exceeds three years from the effective date of the plan ... The commission shall also determine the prospective effect of the electric security plan to determine if that effect is substantially likely to provide the electric distribution utility with a return on common equity that is significantly in excess of the return on common equity that is likely to be earned by publicly traded companies, including utilities, that face comparable business and financial risk, with such adjustments for capital structure as may be appropriate. The burden of proof for demonstrating that significantly excessive earnings will not occur shall be on the electric distribution utility. If the test results are in the negative or the commission finds that continuation of the electric security plan will result in a return on equity that is significantly in excess of the return on common equity that is likely to be earned by publicly traded companies, including utilities, that will face comparable business and financial risk, with such adjustments for capital structure as may be appropriate, during the balance of the plan, the commission may terminate the electric security plan, but not until it shall have provided interested parties with notice and an opportunity to be heard. The commission may impose such conditions on the plan's termination as it considers reasonable and necessary to accommodate the transition from an approved plan to the more advantageous alternative. In the event of an electric security plan's termination pursuant to this division, the commission shall permit the continued deferral and phase-in of any amounts that occurred prior to that termination and the recovery of those amounts as contemplated under that electric security plan.

(F) With regard to the provisions that are included in an electric security plan under this section, the commission shall consider, following the end of each annual period of the plan, if any such adjustments resulted in excessive earnings as measured by whether the earned return on common equity of the electric distribution utility is significantly in excess of the return on common equity that was earned during the same period by publicly traded companies, including utilities, that face comparable business and financial risk,

> with such adjustments for capital structure as may be appropriate. Consideration also shall be given to the capital requirements of future committed investments in this state. The burden of proof for demonstrating that significantly excessive earnings did not occur shall be on the electric distribution utility. If the commission finds that such adjustments, in the aggregate, did result in significantly excessive earnings, it shall require the electric distribution utility to return to consumers the amount of the excess by prospective adjustments; provided that, upon making such prospective adjustments, the electric distribution utility shall have the right to terminate the plan and immediately file an application pursuant to section 4928.142 of the Revised Code. Upon termination of a plan under this division, rates shall be set on the same basis as specified in division (C)(2)(b) of this section, and phase-in of any amounts that occurred prior to that termination and the recovery of those amounts as contemplated under that electric security plan. In making its determination of significantly excessive earnings under this division, the commission shall not consider, directly or indirectly, the revenue, expenses, or earnings of any affiliate or parent company.

DISCUSSION:

Staff Recommendation 1: Should off-system sales be included in the SEET calculation?

Staff proposes that off-system sales (OSS) should be included in the net earnings used to calculate return on equity for the SEET. Staff reasons that OSS are routine operating items and not one-time write-offs or non-recurring items and inclusion of ongoing revenue and expense items for OSS would have a representative effect on the financials. Therefore, Staff concludes that stated financial results, without adjustment for OSS, are appropriate for calculation of the return on equity.

Customer Parties and OPAE concur with Staff's position and add that the return on common equity earned by each of the electric utilities that owns generation could include profits from OSS pursuant to Section 4928.143(F), Revised Code. To eliminate OSS from the SEET calculation, Customer Parties and OPAE argue, would distort the comparison between the electric utility and the comparable group of companies. Further, Customer Parties and OPAE contend that excluding OSS ignores the fact that the cost of the power plant used to make OSS is included in the electric utility's capitalization. Customer Parties offer that including OSS in the SEET calculation results in an unbiased comparison of earnings and promotes fairness by sharing the profits from OSS between customers and the electric utility. Customer Parties assert that the Commission has previously ordered that proceeds from OSS be shared between customers and the electric utility.[3] (Customer Parties Initial at 19; Customer Parties Reply at 4-6; OPAE Reply at 2.) Lastly, Customer Parties support offsetting the electric utility's ESP costs by profits from OSS. Customer Parties argue that sharing OSS profits between customers and the electric utility recognizes that the generation facility was constructed for the benefit of, and ultimately paid for by, jurisdictional customers. (Customer Parties Initial at 19; Customer Parties Reply at 4-6.)

In response, AEP-Ohio argues, among other things, that customers pay rates for retail service and not for the assets that produce those services. AEP-Ohio states that the proposal to share OSS margins is irrelevant and meritless in this proceeding. AEP-Ohio reasons that there is no statutory basis for incorporating a sharing of OSS margins into the SEET application based on Sections 4928.142(D)(4), 4928.143(E) or 4928.143(F), Revised Code, and that the Commission already rejected such arguments in AEP-Ohio's ESP cases. The only authorized adjustments to the SEET are from the company's ESP; to do otherwise, AEP-Ohio argues, would have the effect of disallowing cost recovery already authorized by the Commission. (AEP-Ohio Reply at 3-4.)

DP&L and AEP-Ohio argue that the focus of SB 221 is retail sales and OSS has not previously been included in retail rates under the Commission's jurisdiction. DP&L and AEP-Ohio also note that the purpose of conducting the SEET is to determine if the electric utility's ESP has resulted in excessive earnings for the electric utility and, therefore, it is inappropriate to include non-jurisdictional revenues. The costs and revenues associated with OSS, according to DP&L and AEP-Ohio, should be excluded from earnings in the SEET calculation. DP&L notes that acceptance of Staff's proposal would discourage electric utilities from making OSS, thus placing the interests of ratepayers and shareholders at odds. AEP-Ohio adds that excluding OSS from the SEET calculation also respects the Federal Energy Regulatory Commission's (FERC) jurisdiction and complies with well-settled federal constitutional law. Further, AEP-Ohio argues that under federal constitutional law, the State is preempted from interfering with the Companies' ability to realize revenue rightfully received from wholesale power sales pursuant to contracts or rates approved by FERC. *Pacific Gas & Electric v. Energy Resources Comm.*, 461 U.S. 190 (1983) (*Energy Resources Comm.*); *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953 (1986) (*Nantahala*); *Mississippi Power & Light v. Mississippi*, 487 U.S. 354 (1988) (*MP&L*); *Pacific Gas & Electric Co. v. Lynch*, 216 F. Supp. 2d 1016 (N.D. Cal. 2002) (*Lynch*). AEP-Ohio extends that reasoning to conclude that, just as the State may not trap FERC-approved wholesale power costs, it may not in effect capture or siphon the revenue the Companies receive from FERC-approved wholesale sales for the purpose of reducing the retail rates paid by Ohio customers. Any such order by the Commission, according to AEP-Ohio, would conflict with the Federal Power Act and Congress' power under the Supremacy

3 See, for example, *In the Matter of the Application of the Cleveland Electric Illuminating Company for an Increase in Rates*, Case No. 84-188-EL-AIR, Opinion and Order at 61-65 (March 7, 1985).

Clause and this type of economic protectionism would also violate the federal Commerce Clause. *New England Power Co. v. New Hampshire*, 455 U.S. 331 (1982) (*NEPC*). (DP&L Initial at 2-3; DP&L Reply at 3; AEP-Ohio Initial 2-3.)

In response to the arguments of AEP-Ohio and DP&L, Customer Parties assert that the commenting electric utilities' position is inconsistent with the energy efficiency mandates of SB 221 and explain that customers pay the costs of energy efficiency programs and the power conserved as a result of these programs becomes available for sale in the OSS market. Customer Parties argue that if OSS margins are included in the SEET, OSS can serve as a form of off-set to the energy efficiency costs. However, according to Customer Parties, under AEP-Ohio's position, consumers would pay the full energy efficiency costs while AEP-Ohio would benefit from higher OSS profits made possible by energy efficiency programs. (Customer Parties Reply at 7.)

As to AEP-Ohio's legal argument, that including the OSS profits in the SEET violates the federal law, Customer Parties proclaim that none of the cases cited by AEP-Ohio support that claim. Customer Parties state that the cases cited stand for the proposition that when an electric utility prudently incurs FERC-approved costs, the state may not deny collection of such costs in retail rates. None of the cases deal with the retail ratemaking treatment of OSS margins derived from power plants included in retail rates. (Customer Parties Reply at 7.)

Upon further consideration of the issues raised by the electric industry and Customer Parties regarding OSS, the Commission concludes that this issue is more appropriately addressed in the context of each individual electric utility's SEET proceedings. In order to fully understand the impact of the treatment of OSS on an electric utility's earnings, the Commission directs the electric utility to include in its filing the identification of any OSS and the effect of excluding OSS from and including OSS in the SEET calculation.

<u>Staff Recommendation 2: Should the Commission determine SEET on a single entity basis or company-wide basis?</u>

Staff believes the General Assembly's intent is clearly expressed in the language of Section 4928.143(F), Revised Code, and division (C)(2)(b) of this section, to indicate that the SEET should be calculated for the electric utility as a single entity.

Duke offers that Staff's recommendation fails to take into account the difference in accounting issues where the electric utility wholly owns a subsidiary utility, like Duke owns Duke Energy Kentucky, Inc. (Duke-KY), as opposed to the situation where two electric utilities are owned by a parent holding company. Accordingly, Duke's financial books and records reflect its investment and costs associated with Duke-KY. In addition, Duke indicates that the situation is further complicated since it is a combination utility, offering both electric and gas distribution services. While Duke acknowledges that there may be justification for omitting affiliates and the parent holding company from the SEET calculation for some electric utilities, Duke advocates that a different treatment should apply to electric utilities with wholly owned subsidiaries and combination utilities. Duke contends that separating Duke from Duke-KY and segregating its gas and electric businesses are difficult and the process to do so could easily lead to protracted disputes. Furthermore, Duke argues that if the Staff recommendation is adopted and is interpreted to include the wholly owned subsidiaries of a utility and combination utility operations, an additional process may be required to resolve accounting issues that would arise with regard to the allocation of capitalization between a utility and its wholly owned subsidiaries. (Duke Initial at 2-5.)

Customer Parties respond that Duke has previously been required to file with the Commission electric-only financial information to support its ESP application and electric rate cases. Customer Parties state that in each instance Duke has separated, calculated, and filed all the financial and regulatory information allocated to Duke's electric distribution system to comply with the filing requirements. Accordingly, Customer Parties contend that there is no undue burden imposed on Duke associated with preparing the information on rate base, operating expenses, operating income, return on equity, and rate of return solely for Duke's electric services and there is no reason that the same or similar type of information cannot be made available for the application of SEET. (Customer Parties Reply at 10-11.)

Duke contends that, while it may be relatively straightforward to determine net income on a single entity basis, it is more difficult than Customer Parties represent to extract the equity that supports the subsidiary from the equity of the electric utility. For this reason, Duke reiterates that to follow Staff's narrow interpretation of the statute and exclude all earnings from affiliates, as well as subsidiaries, the Commission should determine the common equity balance attributable to the single entity, the electric utility, on a case-by-case basis in order to review the underlying equity structure of the subsidiaries, and interest and dividend income of the electric utility. (Duke Reply at 2-3.)

AEP-Ohio argues that there are compelling reasons for performing the SEET on CSP and OP on a combined basis, as CSP and OP are vertically integrated electric utilities (generation, transmission, and distribution) and are operated as a single entity, with a single management structure. AEP-Ohio reasons that combining CSP and OP for purposes of performing the SEET helps to promote efficient investment and operating practices, encourages the companies to seek and achieve economies of scale, and is consistent with the Commission's analysis of AEP-Ohio's SSO in their respective ESP. Conversely, AEP-Ohio states that performing the SEET analysis on CSP and OP as separate entities assumes that investment and operations and maintenance (O&M)

spending are determined on a stand-alone basis and could result in the punishment of one of the affiliated electric utilities for management's focus on maximizing efficient investment and O&M spending on a combined-company basis. (AEP-Ohio Initial at 3-4.)

AEP-Ohio maintains that, while CSP and OP maintain different rate structures, those differences do not preclude performing the SEET's earned return on equity calculation on a combined-company basis, as any differences could be taken into account, in the event significantly excessive earnings are determined to have occurred on a combined-company basis, as part of the remedy the Commission adopts for returning such earnings to customers. (AEP-Ohio Initial at 4-5.)

Furthermore, AEP-Ohio reasons that the restriction in Section 4928.143(F), Revised Code, against considering the revenues, expenses, or earnings of "any affiliate or parent company" in the significantly excessive earnings determination, need not preclude the Commission from applying the SEET on a combined-company basis. According to AEP-Ohio, the reference to "affiliates" in Section 4928.143(F), Revised Code, only relates to entities that are not electric utilities, such as competitive retail electric service providers or generation-only and transmission-only companies. If one electric utility's return on equity is considered to be significantly excessive, the statute does not preclude the Commission from considering the combined return on equity of the affiliated electric utility. If that combined return is not significantly excessive that fact can and should be a factor for the Commission to consider and should reduce or eliminate the refund that might otherwise be imposed by the Commission. Lastly, AEP-Ohio argues that if the Commission determines that the statute precludes calculating return on equity on a company-wide basis, the Commission still should consider the policy concerns stated as part of any SEET refund. (AEP-Ohio Initial at 4-5.)

Customer Parties oppose calculating the SEET on a combined basis and assert that the arguments of AEP-Ohio are unsubstantiated and irrelevant to the application of the SEET. The approved rate of return, capital structure, cost of debt, and tariffs of CSP and OP are established separately by the Commission. Further, Customer Parties offer that the application of the SEET on a single-entity basis neither prevents nor precludes CSP and OP from improving operational efficiency or investments or benefiting from various economies of scale. (Customer Parties Reply at 9-10.)

The Commission finds the language in Section 4928.143(F), Revised Code, to be dispositive of whether the SEET is to be calculated for a single-entity or on a company-wide basis. The last sentence of Section 4928.143(F), Revised Code, clearly states that: "In making its determination of significantly excessive earnings under this division, the commission shall not consider, directly or indirectly, the revenue, expenses, or earnings of any affiliate or parent company." We believe that the intent of the language quoted above is to avoid penalizing or rewarding the electric utility for the business operations of its affiliate or parent company. Accepting the arguments of AEP-Ohio to perform the SEET calculation on CSP and OP jointly is not only contrary to the plain language of the statute but would neutralize the earnings of one affiliate, and its customers, over the other. While AEP-Ohio may find it cost-effective for investment and operation and maintenance purposes to make decisions for CSP and OP on a combined-company basis, AEP-Ohio's management decisions do not override the requirements of the statute. As for Duke, with its wholly-owned subsidiaries, we find that the intent of the legislation is to extract, to the extent reasonably feasible and prudently justified, the expenses, earnings, and equity of any affiliate from the SEET calculation. Similarly, where Duke can separate and justify the revenue and expenses associated with its gas distribution service operations from its electric services, we find it appropriate to do so for calculation of the SEET. While making such adjustments may complicate the Duke SEET evaluation, it maintains what the Commission believes to be the intent of the legislation and protects the interest of Duke's electric customers.

<u>Staff Recommendations 3 and 11: What adjustments should be included in the SEET calculation? How should write-offs and deferrals be reflected in the return on equity calculation for SEET?</u>

Staff recommends that stated financial results, without adjustment, should be used for calculation of the SEET and extraordinary items should be excluded. Staff reasons that such definition provides a reasonable, representative, and consistent measure of return on equity. Extraordinary items could overwhelm normal levels of earnings and would not be pertinent to the SEET unless directly tied to an ESP or MRO. Where applicable, adjustments should also be made to remove items associated with non-Ohio service areas. Staff believes that the adjustments created by the implementation of an ESP or MRO are what should be determined on a company-specific basis, only if financial results, as stated, are deemed to be excessive. If excessive earnings, after exclusion of the total adjustments from the earned return, are brought below the threshold deemed to be excessive, then the amount of the excess shall be refunded to the electric utility's customers. If the return with the adjustments excluded is still excessive, then the adjustments cannot be at fault for excessive earnings, and no amount need be returned to the consumers.

Further, Staff recommends that if extraordinary items are created as an adjustment in the ESP or MRO, they should be included for purposes of the SEET in earnings and as adjustments. Extraordinary items that are not created as an adjustment in the ESP or MRO should not be included for purposes of the SEET, either in earnings or as an adjustment. Staff also advocates that OSS should be included as an adjustment in the SEET calculation only when OSS is also included as an adjustment to an electric utility's MRO or ESP. If OSS are not included as an adjustment to the MRO or ESP, then they should not be included as an adjustment in the SEET calculation. OSS are to be included in the earnings, in any case.

Customer Parties concur with the Staff Recommendation concerning the treatment of extraordinary items and OSS, but add that any SEET refund should be excluded from the SEET calculation in the year the refunds are reported on the income statement. (Customer Parties Initial at 15.) No commenters responded to this concern.

Customer Parties recognize that Staff proposes a two-pronged test for determining whether an electric utility's earnings are significantly excessive and subject to refund. Customer Parties assert, however, that the second prong of Staff's test is based on a fundamental misinterpretation of the law. Customer Parties agree that if the ESP rate increases are removed from earnings, and the return on equity is below the SEET threshold, the excess earnings should be subject to refund to the electric utility's customers and no further analysis is necessary. However, Customer Parties assert that the second prong of the analysis, as proposed by Staff, would not result in any refund to customers where the ESP rate increases are excluded from the earnings and the return on equity remains above the established SEET threshold. Customer Parties reason that even if the excess earnings are not a result of the ESP, the ESP contributed to the electric utility's excessive earnings and, therefore, the entirety of the ESP adjustments or rate increase should be returned to customers. Staff's interpretation of the statute, according to Customer Parties, nullifies the very reason for the statute. (Customer Parties Initial at 16-17; Tr. at 7-11.)

As to the adjustments to be included in the SEET calculation, FirstEnergy requests that for the purpose of calculating SEET, net income applicable to common shareholders be adjusted to exclude extraordinary or nonrecurring items which are otherwise non-representative of an electric utility's operations, and any specific adjustments defined in an electric utility's ESP then in effect. The denominator shall be the average monthly common equity balance during the measurement period, adjusted to exclude the related effects of any items excluded from net income. The resulting adjusted return on common equity becomes the reference point, as described in more detail in the company's comments regarding the definition of "significantly in excess of the return on common equity" at Recommendation 5. (FirstEnergy Initial at 2-3.) Customer Parties argue that excluding extraordinary items "which are otherwise non-representative of a utility's operations," as FirstEnergy proposes, would result in mini rate case proceedings and is unworkable. (Customer Parties Reply at 13.)

Duke notes that the Commission approved the stipulation filed in its ESP, which specifically provides that the return on common equity is to be computed using FERC Form 1 financial statements from the prior year, including OSS, subject to certain listed adjustments.[4] Duke mentions that its ESP Stipulation does not indicate that adjustments

4 *In the Matter of the Application of Duke Energy Ohio Inc. for Approval of an Electric Security Plan*, Case No. 08-920-EL-SSO, Opinion and Order (December 17, 2008) (Duke ESP case).

would be made to remove items associated with non-Ohio service areas. Accordingly, Duke objects to the notion that any such change would be made pursuant to this proceeding. (Duke Initial at 5; Duke Reply at 4.) Similarly, FirstEnergy argues that its approved ESP Stipulation includes an express provision excluding deferrals related to deferred carrying charges in the SEET application.[5] Accordingly, FirstEnergy argues that this provision of the approved Stipulation should not be abrogated by this proceeding. (FirstEnergy Reply at 3.) While Duke argues that FirstEnergy's proposal to exclude extraordinary items, nonrecurring items and items that are not representative of an electric utility's operations only from the income statement is inappropriate, Duke supports the proposal as long as the impacts of such adjustments are accounted for in the SEET calculation. (FirstEnergy Initial at 2-3; Duke Reply at 4.)

DP&L avers that, in addition to excluding OSS, other adjustments to the SEET should include significant non-recurring adjustments that are related to regulated operations, such as out-of-period tax adjustments, adjustments for economic conditions, or potential significant loss of load. (DP&L Initial at 3.)

AEP-Ohio states that it agrees with Staff's recommendations regarding the treatment of extraordinary items, but holds that, when correctly interpreted, Staff's proposed treatment of extraordinary items necessitates an adjustment in the calculation of earnings for OSS since OSS are FERC-jurisdictional and associated with non-Ohio service areas. Furthermore, AEP-Ohio clarified its position that if the electric utility is found to have exceeded the significantly excessive earnings threshold, that only those components of the ESP that produce earnings for the electric utility are subject to refund (Tr. 24-25; AEP-Ohio Initial at 5-6.)

Customer Parties urge the Commission to strictly compare an electric utility's earnings to the determined SEET threshold, a one-step process, and if the electric utility's earnings exceed the threshold, adjust the electric utility's earnings accordingly. Customer Parties' proposal essentially establishes a cap on the electric utility's return on equity rather than ensures that the ESP adjustments do not result in significantly excessive earnings as Section 4928.143(E), Revised Code, requires.

Based on the clear, unambiguous language of the statute, the Commission is directed to analyze whether the ESP is the cause of the electric utility's significantly excessive earnings. The Commission finds the "one-step process" to be more appropriate than the two-pronged analysis advocated by Staff. In the context of the SEET analysis, it is unreasonable to presume that even if the electric utility was very profitable prior to the ESP, the adjustments in the ESP would not be adding to excess earnings. We also believe that the two-step analysis could encourage gaming by the electric utilities. The clear,

5 *FirstEnergy ESP cases*, Stipulation (February 19, 2009), paragraph B.6 at 17.

unambiguous language of the statute limits the amount of any refund to customers to the adjustments in the current ESP. More specifically, an adjustment for purposes of Section 4928.143(F), Revised Code, includes any change in rates when compared to the rates in the electric utility's preceding rate plan. Therefore, in any given year, the earnings, which if significantly excessive, subject to being returned is the difference between those earned under the rate in place in that year and what would have been earned if the utility's preceding rate plan had been in place in that year. For example, in the year 2010, the comparison for most electric utilities would be to the rates from the preceding rate plan for 2008. Thus, the Commission reasons that in 2010, we would not be permitted to "claw back" into 2009 profits if the 2009 profits were not significantly excessive. We find FirstEnergy's arguments to be persuasive. FirstEnergy reasoned that in the first sentence of Section 4928.143(F), Revised Code, the phrase "any such adjustments" should be read as referring to the first part of the sentence and the phrase, "the provisions that are included in an electric security plan under this section" (Tr. 20-22). We note that Customer Parties seem to agree with FirstEnergy's interpretation (Tr. 16-17, 18-19). Finally, we also agree, as Customer Parties emphasize, that any adjustment to the earnings of an electric utility, as a result of a refund, should be excluded from the SEET calculation in the year the adjustment is made to avoid distorting the electric utility's income. In order to facilitate the valuation of the ESP adjustments, the electric utilities are directed to include in their SEET filings the difference in earnings between the ESP and what would have occurred had the preceding rate plan been in place.

As to Staff Recommendation 11, regarding how write-offs and deferrals should be reflected in the return on equity calculation for SEET, Customer Parties advocate that any deferral of fuel costs or other items should be reflected in the return on equity calculation for SEET in the year when the retail sales occur, not in later years when the deferred revenues are received. Customer Parties argue that such would be consistent with Staff's recommendation that stated financial results should be used for calculation of the SEET. Customer Parties suggest that in any year where there is a deferral and a SEET finding of excess profits, that the excess profits could first be used to pay down the deferrals before any refund is awarded to customers. (Customer Parties Initial at 15-16; Tr. 34-35.)

AEP-Ohio disagrees, maintaining that a SEET obligation to return significantly excessive earnings due to ESP adjustments should not be premised on deferrals since the electric utility has not yet received the cash that would have to be returned. Further, AEP-Ohio argued that Section 4928.143(F), Revised Code, should not be applied in a manner that underminds the probability of the electric utility's future recovery of deferrals that were previously authorized by the Commission and jeopardizes the utility's ability to create the deferral to phase-in rate increases and moderate customer rate impacts and contends that Section 4928.144, Revised Code, supports its interpretation. (AEP-Ohio Reply at 4-5; Tr. 26-33, 36-37.)

OPAE argues that the focus of the SEET is to protect consumers and it is not necessary to put deferrals, booked pursuant to generally accepted accounting principles, at issue to achieve the goal of the SEET. OPAE believes the electric utility's revenues, in total, should be considered in the SEET analysis. (Tr. at 33-34.)

Duke explained that there are two types of deferrals. One type is deferred revenue with an underlying expense, like the FAC expense in AEP-Ohio's case. Duke argues that it would be unfair to require the electric utility to recognize the revenue or incur expense until it is received. The second type of deferral, according to Duke, is a deferred rate increase which may not have an underlying expense and is different in concept than the first type of deferral. (Tr. 35-36.)

The Commission recognizes that the issues surrounding the treatment of deferrals are extremely complex. The Commission notes that granting a company the ability to defer expenses does not equate to the unequivocal right to collect the deferral. However, deferrals are a regulatory tool used by the Commission to avoid rate shock to customers and as such can be a public benefit. The Commission is also mindful that from a financial reporting perspective that the recovery of deferrals by an electric utility needs to be fairly known so that it may be treated appropriately for accounting purposes. The Commission understands that to cast an unacceptable level of doubt on the recovery of a deferral, particularly a large deferral, will severely dampen the electric utility's willingness to agree to deferrals. Because many factors need to be considered in order to weigh the appropriateness of the treatment of any given deferral, the Commission finds that the treatment of deferrals, for purposes of the SEET, should be determined on a case-by-case basis. To facilitate the Commission's consideration of an electric utility's deferrals, in their SEET filings, the electric utility should identify any deferrals and the effects of excluding and including the deferrals in the SEET calculation. Furthermore, similar information should also be provided for extraordinary items.

In regards to Staff's recommendation 11, the Commission further finds that where an electric utility's ESP or MRO has been resolved by stipulation, which includes a method for the treatment of write-offs and deferrals in calculating the SEET, the Commission is not modifying the stipulation with this proceeding, to the extent that the issue is adequately addressed in the stipulation and the order approving the stipulation. Accordingly, the approved standard service offer stipulations of Duke and FirstEnergy shall stand as approved by the Commission to the extent the treatment of deferrals and write-offs in the SEET calculation were addressed.

As discussed further, in regard to Recommendation 10, the Commission will determine how any significantly excessive earnings are returned to customers based on the circumstances of the company-specific case.

Staff Recommendation 4: What is the precise accounting definition of "earned return on common equity" that should be used?

Staff proposes, and Customer Parties concur, that earned return should be the net income for the year divided by the average common equity over all months of the year with extraordinary items excluded. (Customer Parties Initial at 21.) Staff reasons that this definition is consistent with the use of stated financials with minimal adjustments. DP&L agrees that "earned return on common equity" should mean net income divided by average common equity. However, DP&L recommends that preferred dividends be excluded from net income and that average common equity be calculated using 13 monthly balances rather than the average of 12 calendar month balances. DP&L reasons that including December of the previous year reflects the capital structure that was in place for the full calendar year. (DP&L Initial at 4.)

For clarity, AEP-Ohio requests that, in the equation proposed by Staff, the numerator, net income, be defined as profit after deduction of all expenses, including taxes, minority interest, and preferred dividends, paid or accumulated, and excluding any non-recurring, special, and extraordinary items, and the denominator is average book equity as determined by averaging beginning of the year equity and end of the year equity. Further, AEP-Ohio argues that the earned return on common equity should not include deferred fuel adjustment clause (FAC) expenses. More specifically, AEP-Ohio explains that an electric utility should not be made to refund deferred amounts it has not yet collected. Instead, during the deferral period of AEP-Ohio's 10-year phase-in (2009-2011) all deferrals of FAC expenses would be excluded from the SEET and, during the recovery period of the phase-in (2012-2018), FAC expenses associated with the amounts previously deferred would be excluded from the SEET. (AEP-Ohio Initial at 7-8.)

Like DP&L and AEP-Ohio, FirstEnergy concurs that the methodology selected should capture an average of common equity over all months of the year as opposed to use of an unrepresentative, single point measure of equity. FirstEnergy also recommends that the exclusion of extraordinary or nonrecurring items, or those which are otherwise non-representative of the electric utility's operations, in order to maintain comparability with the sample of companies against which the electric utility's earnings are being considered. (FirstEnergy Initial at 3.)

Customers Parties object to AEP-Ohio's recommendation, specifically, that earned return on common equity exclude FAC revenues and, generally, that FAC revenues and expenses be excluded from the SEET calculation during the ESP period of 2009-2011 and also the recovery period of 2012-2018. Customers Parties argue such treatment would forever deny consumers a proper accounting. Customer Parties recommend that any deferral of fuel costs or other items should be reflected in the return on equity calculation for SEET in the year when the retail sales occur, not in later years when the deferred revenues are received. Deferrals, according to Customer Parties, could be included in earnings and any excess profits should first be used to pay back the deferral before there are any cash refunds. However, Customer Parties express concern about pre-determining that deferrals should be collected from customers. (Customer Parties Reply at 14-15.)

Duke asserts that, while there appears to be some agreement between Staff and commenters that earned return on common equity is equal to net income available for common equity divided by some average of common equity balance, it may be necessary to carve out additional equity, in addition to adjusting the equity balance for any net income adjustments. (Duke Reply at 4-5.)

We find that Staff's proposal, with some commenter clarifications, is appropriate for the purpose of determining whether an electric utility has had significantly excessive earnings. Accordingly, for the SEET calculation, the earned return will equal the electric utility's profits after deduction of all expenses, including taxes, minority interest, and preferred dividends, paid or accumulated, and excluding any non-recurring, special, and extraordinary items. The average book equity used to calculate the SEET will be the book equity for the 12-month period. The Commission is not convinced that using the 13 monthly common equity book balances, as proposed by DP&L, is likely to lead to a significantly different result than the 12-month average. Furthermore, as the Commission declines, at this time, to make a generic finding with respect to the treatment of deferrals, the Commission directs the electric utilities to file their earnings with the inclusion of deferrals and also without the inclusion of deferrals.

Staff Recommendation 5: What is the definition of "significantly in excess of the return on common equity"?

Staff recommends that a return on common equity of the greater of 200 basis points above the mean or in excess of 1.28 (expressed as basis points) times the standard deviation above the mean of a comparable group of companies should be defined as significantly in excess. Assuming a normal distribution, this would establish a level of return below which 90 percent of the sample of comparables would fall. This methodology was used by Michael J. Vilbert in direct testimony filed in FirstEnergy's SSO cases and Staff believes the resultant level of return defined as significantly in excess to have been reasonable.[6] Two hundred basis points above the mean would act as a backstop when earnings are low.

Customer Parties' primary concern is the definition of "significantly in excess of the return on common equity" as Customer Parties believe it is the foundation of the consumer protection aspect of SB 221. Customer Parties contend that through the SEET,

6 *FirstEnergy ESP case*, Application, Ex. 8 at Appendix B-3 (July 31, 2008).

the legislature determined that Ohio electric consumers cannot be required to fund significantly excessive utility profits.

Customer Parties note that Staff's recommendation on this issue is a complete departure from Staff's position in the AEP-Ohio and FirstEnergy ESP cases, as demonstrated by the direct testimony of Staff witness Cahaan in the AEP-Ohio ESP case.[7] Customer Parties argue that the use of a statistical standard deviation approach requires an assumption that the return on equity for the comparable companies are normally distributed, and no evidence presented in the AEP-Ohio or FirstEnergy ESP proceedings supports such an assumption. AEP-Ohio retorts that this assumption exists with any statistics-based methodology and there is no basis for concluding that the returns on equity of a yet to be determined comparable group will not be normally distributed. Thus, AEP-Ohio argues that Customer Parties' criticism is without merit. (AEP-Ohio Reply at 8-9.)

Next, using AEP-Ohio witness Makhija's comparable group for 2007 as an example, Customer Parties argue that the proposed method may result in unreasonable SEET return on equity thresholds, in this case 55.5 percent.[8] Customer Parties maintain that this is not some inherent flaw in the SEET, as the test is very similar to the "comparable earnings" standard used by public utilities across the United States for years; the U. S. Supreme Court upheld the constitutionality of this standard in *Bluefield Water Works v. West Virginia*, 262 U.S. 679, 692 (1923) (*Bluefield*); and *F.P.C. v. Hope Natural Gas*, 320 U.S. 591, 603 (1944) (*Hope*). Further, Customer Parties note that, in comparison to the potential result of Dr. Makhija's methodology, for the first nine months of 2009 in 22 cases the average electric utility's return on equity authorized by state commissions was 10.43 percent, with the highest return on equity being 11.39 percent in 22 cases for the year 1996.[9] Customer Parties prefer the use of the threshold of 200-400 basis points above the mean return of the sample group instead of the recommendation now advocated by Staff. This approach was supported by OEG witness King in AEP-Ohio's ESP proceedings.[10] Mr. King proffered that the SEET threshold be set at a simple 200 basis points above the mean return of the comparable companies group. Customer Parties state that a 200 basis point premium is equal to the return on equity adder used by FERC to incentivize utilities to make especially risky transmission investments and provides an ample return on equity premium. Finally, Customer Parties reason that as long as the Commission retains ultimate authority regarding the return on equity premium to be added to the comparable

---

7 *AEP-Ohio ESP cases*, Direct Testimony of Staff witness Cahaan (November 7, 2008).

8 The greater of: a) 13.91 percent plus 200 basis points which equals 15.91 percent; or b) 13.91 percent plus (32.51 multiplied by 1.28) which equals 55.5 percent. See *AEP-Ohio ESP cases*, Direct Testimony of AEP-Ohio witness Makhija (July 31, 2008).

9 Regulatory Research Associates, Regulatory Focus, October 2, 2009.

10 *AEP-Ohio ESP cases*, Direct Testimony of OEG witness King (November 3, 2008).

group return on equity, then a reasonable balancing of customer and shareholder interests can be maintained under any economic conditions. (Customer Parties Initial at 3-11.)

AEP-Ohio states that the use of a statistical approach for determining the SEET threshold is appropriate. Further, AEP-Ohio argues that Customer Parties have mischaracterized Dr. Makhija's testimony filed in AEP-Ohio's ESP proceeding. AEP-Ohio explains that, with a 95 percent confidence level, using 2007 data, results in a comparable group with a mean return on equity of 13.9 percent, an adder of 13 percent, and a significantly excessive earnings threshold of 26.9 percent. AEP-Ohio further states that using Dr. Makhija's method with a 90 percent confidence level or a 1.28 standard deviation variance reduces the adder to 8.3 percent, and when added to the mean return on equity of 13.9 percent yields a return on equity threshold of 22.1 percent for 2007, not an increase of 28 percent to 55.5 percent, as Customer Parties claims. (AEP-Ohio Reply at 8.)

In response to the criticism of Customer Parties, FirstEnergy notes that, while Customer Parties lament the use of a statistical criterion, Dr. Woolridge's approach, which Customer Parties supported in the FirstEnergy ESP proceeding, proposed the use of a statistical based criterion as the mechanism by which to define "significantly excessive earnings."[11] FirstEnergy, AEP-Ohio, and Duke further challenge Customer Parties' recitation of *Bluefield* and *Hope* as irrelevant to the issue of whether an electric utility has significantly excessive earnings during a given period in comparison to other businesses with similar business and financial risk. Duke argues that the Bluefield and Hope cases apply to FERC's setting of rates. Further, Duke also asserts that the Commission is not governed by federal law or case precedent and that those principles are inapplicable to Commission practice. FirstEnergy notes three specific differences in the analysis at hand as opposed to the rate of return on equity at issue in *Bluefield* or *Hope*. First, FirstEnergy argues, and AEP-Ohio agrees, that the determination of what rate of return should be allowed in a rate case is a forward-looking exercise which attempts to capture the return that will be required by an investor to make a future investment. In contrast, the SEET determination is a retrospective look at the financial results achieved in a prior fiscal period. Second, the commenting electric utilities agree that ascertaining an appropriate allowed rate of return focuses on market-based measures while the SEET relies on a comparison of accounting or book-based measures. Third, FirstEnergy opines that in setting an allowed rate of return, there is an inherent expectation that an electric utility may at times earn slightly more or less than the precise return on equity allowed; however, over time and on average, the electric utility will earn its allowed return. FirstEnergy and AEP-Ohio argue that the SEET mechanism presents the prospect that the electric utility may be required to return to customers that portion of earnings which is deemed to be "significantly excessive" and that requirement is not balanced out by any offsetting mechanism applicable in a period of particularly low earnings. Thus, FirstEnergy

11 FirstEnergy ESP case, Tr. V at 30 (October 22, 2008); FirstEnergy Reply Brief at 90.

concludes that determining the proper rate of return and the SEET application are fundamentally different. (FirstEnergy Reply at 4-5; AEP-Ohio Reply at 6-11; Duke Reply at 7.)

AEP-Ohio responds that Customer Parties' proposal to use a 200 basis points premium to the return on equity is a misguided comparison to the adder used by FERC to incent utilities to invest in new transmission line projects. AEP-Ohio reasons that the adder used by FERC is not, by definition, set at a significantly excessive level, but is based on a traditional just and reasonable standard. Further, AEP-Ohio surmises that the use of the FERC adder overlooks the SEET statutory requirement to establish the threshold for excessive earnings based on matching the business and financial risks of an electric utility to a group of comparable companies or change with economic conditions and the performance of comparable firms. (AEP-Ohio Reply at 10.)

Duke disagrees with the Staff proposal. In Duke's ESP case, Duke witness Rose recommended using a 95 percent confidence level or 1.64 standard deviations above the mean.[12] Mr. Rose advocated using a comparable group that is weighted by traditionally regulated utilities and fully non-regulated industries. Duke believes this is the threshold that defines the level of earnings that is "significantly excessive." Duke surmises the legislature included the adjective "significantly" in order to avoid capturing situations in which earnings are just somewhat higher than average. Without a threshold at the 95 percent confidence level, it is difficult to conclude that earnings are significantly excessive. In response to Customer Parties' support of 200 basis points above the mean approach, DP&L presents that two standard deviations is a more appropriate threshold for SEET and would result in only those companies that truly have "significantly excessive earnings." (Duke Initial at 6; DP&L Initial at 4; DP&L Reply at 2.)

Also, Duke argues that Staff's recommendation, which it attributes to FirstEnergy's witness Vilbert, disregards a significant qualification made by Dr. Vilbert that his recommended confidence level would increase from 1.28 standard deviations if a comparable group of companies is limited to regulated electric utilities for purposes of calculating the SEET.[13] For this reason, Duke contends that the Commission should recognize the impact of the composition of the comparable group in the determination of the confidence level. Duke interprets Section 4928.142(D)(4), Revised Code, to require electric utilities and other publicly traded companies to be part of the comparison group, with a commensurate standard deviation above the mean. (Duke Initial at 6; Duke Reply at 6-7.)

[12] Duke ESP case, Direct Testimony of Duke witness Rose (July 31, 2008).

[13] FirstEnergy ESP case, Direct Testimony of Vilbert (July 31, 2008).

DP&L's comments focus on the word "significantly" and suggest that the Commission find significantly excessive earnings if an electric utility earns more than 2.00 standard deviations beyond the average of the comparable companies. DP&L notes that Vilbert's testimony represents that two standard deviations would result in 2.3 percent of the companies in the sample having earnings beyond the range of reasonableness and, therefore, deemed "significantly excessive earnings." In light of Dr. Vilbert's representation, Staff's recommendation of 1.28 standard deviations would result in 10 percent of the comparable companies' earnings beyond the range of reasonableness and their earnings excessive. DP&L argues that the test is for "significantly excessive earnings" and, thus, should not apply to 10 percent of the comparable companies each year. (DP&L Initial at 4.) Instead, DP&L also supports that two standard deviations is the more appropriate threshold for SEET and would result in a finding of only those companies that truly have "significantly excessive earnings." (DP&L Reply at 2.)

AEP-Ohio primarily agrees with the Staff recommendation but suggests that the multiplier for the standard deviation-based adder should be 2.00, rather than 1.28 as the Staff proposes. The 2.00 standard deviation level, which corresponds to a 95 percent confidence level, is a more commonly used measure of what is significantly above (or below) the mean than is a 1.28 standard deviation level (corresponding to a 90 percent confidence level).[14] (AEP-Ohio Initial at 8-9.) As discussed in detail in its initial comments, Customer Parties admonish AEP-Ohio's proposal for a 2.00 standard deviation adder, which by Customer Parties' calculations would yield a 78.9 percent return on equity, as unreasonable on its face and another example of why the statistical method is unreasonable and should be rejected. (Customer Parties Reply at 18.)

FirstEnergy explains that the Staff recommended methodology reflects the most conservative acceptable statistical confidence level of 90 percent. Further, FirstEnergy notes that this method and confidence level, assuming the sample group would include companies from industries other than the electric utility industry, reduces the prospect of a "false positive" result where the SEET would incorrectly identify the electric utility's earnings as significantly excessive, and mitigates the likelihood of imposing an asymmetric risk upon the electric utilities with regard to the electric utility's ability to actually earn the return allowed by the Commission.[15] However, FirstEnergy points out that if the sample of comparable companies is more restrictive it would be appropriate to use a higher confidence level of 95 percent or 97.5 percent. The higher confidence level is appropriate, as FirstEnergy reasons, since there is less variance in distribution of returns within more restricted samples and, therefore, the danger of the test resulting in false positives is increased and may yield an incorrect implication of significantly excessive

---

[14] AEP-Ohio ESP cases, Direct and Rebuttal Testimony of AEP-Ohio witness Makhija (July 31, 2008 and December 8, 2008).

[15] FirstEnergy ESP case, Companies' Exhibit 8, Direct Testimony of FirstEnergy witness Vilbert at 14-20 (July 31, 2008).

earnings.[16] Moreover, FirstEnergy emphasizes that beyond the mechanical application of a mathematical test, Section 4928.143(F), Revised Code, requires the Commission to consider the capital requirements of future committed investments in Ohio. (FirstEnergy Initial at 4-5.)

With respect to the appropriate "backstop" level, FirstEnergy and AEP-Ohio concur in Staff's recommendation to adopt, and the rationale for implementing, 200 basis points as a minimum increment above the mean return for the comparable companies as a "backstop." (FirstEnergy Initial at 5; AEP-Ohio Initial at 9.)

Duke believes that Staff's proposal to use 200 basis points rather than the 1.28 standard deviation is appropriate in difficult economic times (Duke Initial at 6). DP&L recommends that the electric utility's regulated return on equity established in its most recent rate proceeding plus 30 percent, be used as the appropriate backstop for determining significantly excessive earnings (DP&L Initial at 4-5).

Customer Parties state that DP&L's recommendation is not based on the company's testimony in its ESP or any other case and is, thus, without foundation. Further, Customer Parties request clarification of whether the 30 percent is an adjustment made as a percentage of the established return on equity as opposed to an adjustment of 30 percentage points over the established return on equity, and notes that the established rate of return on common equity for most of Ohio's electric utilities was established in rate proceedings ten to 15 years ago and have little relevance to the current cost of capital and economic conditions. Accordingly, Customer Parties oppose DP&L's backstop recommendation. (Customer Parties Reply at 17.)

Because the comments received in response to Recommendation 5 intertwine with the comments received in response to Recommendation 7, the Commission's finding with respect to Recommendation 5 will be provided in the discussion of its findings in response to Recommendation 7 so that interested stakeholders have a cohesive synopsis of the methodology establishing the SEET threshold.

Staff Recommendations 6 and 9: How should companies "that face comparable business and financial risk" be determined? How should the earnings of a comparable company be adjusted to compensate for the financial risk difference associated with the difference in capital structures?

In regard to the method for comparable group sample selection, Staff suggests that since different companies are structured differently and economic conditions will vary over time, the comparable group samples should vary case-to-case. While leverage can be

---

[16] Id. at 16.

used as a factor in the group selection, Staff believes that not doing so and adjusting the resulting returns for the comparable group companies is preferable, as this enables a larger sample to be used. A larger sample enables greater validity for the results. Staff would leave this choice to the discretion of the Applicant companies as doing so would be consistent with the case-by-case group selection policy and because the leverage consideration is of secondary significance.

DP&L agrees with Staff that the comparable companies should vary on a case-by-case basis to reflect different company structures, business profiles, and economic conditions and that the earnings of the comparable companies may be adjusted on a case-by-case basis to account for different capital structures consistent with paragraphs (E) and (F) of Section 4928.143, Revised Code. (DP&L Initial at 5-6.)

AEP-Ohio generally concurs with Staff's recommendation and observations and, in particular, the recommendation that the choice for selecting the comparable group would be at the discretion of the electric utility (AEP-Ohio Initial at 10).

FirstEnergy suggests that the method for selecting comparable companies be uniformly applied to all Ohio electric utilities pursuant to the process set out in the FirstEnergy ESP cases. A uniform selection method, according to FirstEnergy, reduces potential uncertainty in the application of the SEET from year to year and from electric utility to electric utility but allows, if the specific circumstances presented justify, a departure from application of the uniform methodology on a limited basis. (FirstEnergy Initial 5-6.) FirstEnergy advocates the comparable companies selection process presented by FirstEnergy witness Vilbert in the FirstEnergy ESP case.[17]

FirstEnergy also supports, as advocated by FirstEnergy in its ESP proceeding and most recent distribution rate case, the Staff recommendation regarding the financial risk of comparable companies and notes such approach facilitates a larger sample of comparable companies to be used, which improves the validity of the results. (FirstEnergy Initial 6.)

Customer Parties and OPAE note that Staff originally advocated that a single methodology for selection of comparable companies be used for all electric utilities.[18] Customer Parties and OPAE contend that selection of the comparable group is critical for

---

17 FirstEnergy ESP case, Direct Testimony of Vilbert at 10-14 (July 31, 2008). Dr. Vilbert's methodology may be summarized as follows: (1) determine that the companies have business risk similar to that of the electric utility selecting : (a) companies that operate in industries that rely on a network of assets to provide services to a customer mix that includes residential, commercial and industrial customers; and (b) the companies have high capital intensity; (2) adjust for differences in capital structure by adjusting the measure of return on capital; and (3) eliminate companies that: (a) have a credit rating below investment grade; (b) foreign companies; and (c) the necessary information to compute the asset turnover measure is not available.

18 AEP-Ohio ESP cases, Direct Testimony of Staff witness Cahaan (November 7, 2008).

two reasons. First, selection of the comparable group determines the mean (average) rate of return on equity and, second because the comparable group also determines the variability of earnings from which the statistical standard deviation is derived. Customer Parties argue that the recommended method will result in unreasonable return on equity thresholds. (Customer Parties Initial at 4, 12; OPAE Reply at 4-5; Tr. 40-41.)

Customer Parties insist that a common methodology for the selection of a comparable group of companies is essential to the SEET. If, as proposed by Staff, this issue is decided on a case-by-case basis, Customer Parties argue that this aspect of the SEET calculation will essentially be a mini rate case. Customer Parties propose the methodology offered by OCC witness Woolridge in the electric utility ESP cases be implemented for all electric utility SEET proceedings. (Customer Parties Initial at 13; Tr. 41.)[19]

AEP-Ohio asserts that Customer Parties' comparable group selection process is flawed to the extent that the process limits comparable firms to only those with the characteristics of other electric utilities, contrary to the language of Section 4928.143(F), Revised Code, and fails to consider the business and risk characteristics of the electric utility. Thus, AEP-Ohio points out that Customer Parties' proposed selection process results in the same list of comparable firms for each Ohio electric utility and, therefore, assumes that the risk of FirstEnergy's electric utilities, which are insulated from generation and transmission risks, is equivalent to the risk faced by AEP-Ohio, even though AEP-Ohio is not insulated from generation and transmission risks. Accordingly, AEP-Ohio continues to support a case-by-case approach to applying the SEET methodology to each electric utility, including the determination of the comparable group. (AEP-Ohio Reply 12-13.)

In regards to how the earnings of comparable companies should be adjusted for the financial risk difference associated with the difference in capital structure, Customer Parties assert there is consensus among three of the experts who offered testimony in the

[19] AEP-Ohio ESP cases, Direct Testimony of OCC witness Woolridge (October 31, 2008). Woolridge's methodology may be summarized as follows: (1) Identify a proxy group of electric utilities that must have: (a) an investment grade bond rating; (b) total revenue less than $ 10 billion; (c) percent of regulated electric revenue of at least 75%; and (d) a three-year history of paying cash dividends. (2) Identify a list of business and financial risk measures to insure that the comparable private sector companies are similar to the proxy group of electric utilities. These business and financial risk measures are: (a) stock price beta (a measure of stock price volatility); (b) asset turnover ratio (measures capital intensity); (c) common equity ratio (shareholder equity as percent of total capitalization); and (d) no foreign companies. (3) Determine the business and financial risk measures identified above (beta, asset turnover ratio, and common equity ratio) for the proxy group of electric utilities. (4) Use the beta, asset turnover ratio, and common equity ratios for the proxy group of electric utilities to screen the thousands of companies in the Value Line database. The result was 64 comparable companies, 44 of which were electric utilities. (5) Calculate the mean (average) ROE for the 64 company comparable group. (6) Finally, adjust the mean (average) ROE for the 64 company comparable group for the actual capital structure of the Ohio electric utility being examined.

ESP cases — Dr. Woolridge, Dr. Vilbert and Mr. King. The process involves computing the pre-tax return on capital for the comparable companies, and then making adjustments to reflect the difference in the benchmark return on equity based on the capital structure of the Ohio electric utility relative to the average of the comparable public companies. Dr. Woolridge's three-step process to make this adjustment includes:

(1) Compute the average pre-tax return on total capital for the comparable group of public companies, using the average return on equity, debt/equity percentages, income tax rates, and long-term debt cost rates;

(2) Compute the pre-tax return on equity for the Ohio electric utility using: (a) the average pre-tax return on total capital for the comparable companies; and (b) the individual debt/equity percentages, income tax rates, and long-term debt cost rates of the Ohio electric utility; and

(3) Compute the after-tax benchmark return on equity for the Ohio electric utility using its income tax rates.

Customer Parties assert that, using 2007 data, Dr. Woolridge's methodology results in a comparable group with a mean return on equity of 11.37 percent and a relatively stable standard deviation of 4.2. By contrast, Dr. Makhija's 2007 comparable group had a mean return on equity of 13.91 percent and a standard deviation of 32.51. The OCC and FirstEnergy witnesses both determined a similar mean return on equity (11.37 percent versus 13.91 percent). Customer Parties recognize that the standard deviation of the OCC's and AEP-Ohio's comparable group was widely different, 4.52 versus 32.51, which demonstrates why statistical standard deviation approach to SEET cannot be relied upon for protecting customers under the statutory standard. (Customer Parties Initial at 13-14.)

Customer Parties acknowledge that SB 221 explicitly states that the capital structure of the electric utility should be considered and accounted for in assessing the SEET. However, Customer Parties are concerned that the Staff recommendation makes consideration of the capital structure a secondary consideration and also that it should not be determined on a case-by-case basis. Further, as stated previously, Customer Parties object to each electric utility selecting the comparable group of companies pursuant to Dr. Vilbert's method since the statute requires that leverage (i.e., ratio of common equity) consideration be given primary and explicit consideration in the group selection process. Customer Parties assert that FirstEnergy's proposal ignores the leverage consideration in the sample group selection and instead adjusts the resulting return. (Customer Parties Reply at 19-20.)

Lastly, while Customer Parties and FirstEnergy both support a uniform statewide method for determining comparable companies, Customer Parties argue that the method proposed by FirstEnergy is flawed, unreasonable, and arbitrary and includes no risk measures. Customer Parties claim that if the Commission believes that the distribution-only FirstEnergy utilities are less risky than generation-owning utilities, then that factor can be accounted for with a lower basis point premium above the benchmark return. (Customer Parties Reply at 19-20.)

FirstEnergy challenges Customer Parties' representation that Dr. Woolridge, Dr. Vilbert and Mr. King "provide much the same methodology" for making the adjustment to account for financial risk. FirstEnergy states that there is considerable difference between the mechanism proposed by Dr. Vilbert and that offered by Dr. Woolridge and Mr. King, as Staff witness Cahaan recognized.[20] The uniform methodology for selection of the comparable companies as advocated by Dr. Woolridge is amiss with shortcomings and deficiencies, as FirstEnergy allegedly demonstrated in its briefs in its ESP case. DP&L asserts that a common methodology fails to recognize that each of the Ohio electric utilities have different financial and business risks. Further, FirstEnergy, AEP-Ohio, Duke, and DP&L note that Customer Parties' criticism overlooks the fact that under Section 4928.143(F), Revised Code, the electric utility bears the burden of proof on the SEET determination and that it is the Commission that will determine if the burden has been sustained. FirstEnergy reasons it is procedurally customary for the party with the burden of proof to present its case and prove its methodology with the active participation of interested persons. Further, AEP-Ohio points out that the electric utility cannot dictate the comparable group of companies as the statute sets forth the basis for evaluating the group of comparable companies. (FirstEnergy Reply at 8-10; AEP-Ohio Reply at 6-7; Duke Reply at 7-8; DP&L Reply at 2-3.)

At this time, the Commission declines to predetermine which companies shall be included in the "comparable group" in determining the SEET. Because each electric utility is unique, and conditions are constantly changing, the Commission does not believe it to be prudent to establish a comparable group process now which may be subject to change. All parties acknowledge that, at a minimum, there may need to be "tweaks" to a comparable group, among the companies and over time, if the group were predetermined now. The Commission also notes that it is the electric utility that will bear the burden of proof of demonstrating that its preferred comparable group is appropriate. As with other cases wherein earnings are considered, it is the Commission that will make the final decision as to the appropriate mix of companies comprising the "comparable group." Therefore, the Commission will decide the comparable group on a case-by-case basis each year. Doing so, fosters the goal of ensuring that the comparable group reflects current general market conditions and that of the individual electric utility.

---

20 FirstEnergy ESP case, Tr. Vol. IX at 119 (October 28, 2008).

Staff Recommendation 7: How are "significantly excessive earnings" to be determined, as that phrase is used in the third sentence of Section 4928.143(F), Revised Code?[21]

Staff recommends that significantly excessive earnings be measured by whether the earned return on common equity of the electric utility is significantly in excess of the return on common equity that was earned during the same period by publicly traded companies, including utilities that face comparable business and financial risk, with such adjustments for capital structure as may be appropriate. Staff endorses the concept that a return on common equity in excess of 1.28 times the standard deviation above the mean of a comparable group of companies should be defined as earnings significantly in excess, except in a low earnings environment when 200 basis points could be substituted.

AEP-Ohio agrees with the Staff's recommended approach; however, as discussed above in Recommendations 5, 6, and 9, regarding the definition of "significantly in excess of the return on common equity," and comparable companies, AEP-Ohio proposes that 2.00 standard deviations, rather than 1.28 standard deviations, should be used as the adder to determine the threshold for significantly excessive earnings. DP&L agrees with AEP-Ohio's claims and recommendation on this issue. (AEP-Ohio Initial at 10; DP&L Reply at 3.)

Customer Parties disagree with Staff's recommendation on this matter, arguing instead that a 200 basis point premium above the mean return of the comparable group is appropriate and should also recognize upcoming major capital expenditures of the electric utility, subject to certain conditions precedent. (Customer Parties Initial at 2, 8-9, 22; Tr. 37-39.) AEP-Ohio asserts that Customer Parties' proposal is misguided, as the company states in its comments in regard to Recommendations 3 and 9, above. (AEP-Ohio Reply 14.)

FirstEnergy reiterates its comments made with regard to Recommendation 5, the definition of "significantly in excess of the return on common equity." (FirstEnergy Initial at 4-6.) At the question and answer session, FirstEnergy interpreted Section 4928.143(F), Revised Code, to provide the Commission with some discretion to be used on a case-by-case basis to adjust the earnings of the electric utility in comparison to the comparable group (Tr. 39-40).

Having fully considered all the comments regarding establishing the threshold and in consideration of the discretion afforded the Commission in SB 221, the Commission

[21] The third sentence of Section 4928.143(F), Revised Code, states:
"The burden of proof for demonstrating that significantly excessive earnings did not occur shall be on the electric distribution utility."

concludes that "significantly excessive earnings" should be determined based on the reasonable judgment of the Commission on a case-by-case basis.

The Commission notes that within Ohio's electric utilities, there is significant variation, including, for example, whether the electric utility provides transmission, generation, and distribution service or only distribution service. For this reason, the Commission will give due consideration to certain factors, including, but not limited to, the electric utility's most recently authorized return on equity, the electric utility's risk, including the following: whether the electric utility owns generation; whether the ESP includes a fuel and purchased power adjustment or other similar adjustments; the rate design and the extent to which the electric utility remains subject to weather and economic risk; capital commitments and future capital requirements; indicators of management performance and benchmarks to other utilities; and innovation and industry leadership with respect to meeting industry challenges to maintain and improve the competitiveness of Ohio's economy, including research and development expenditures, investments in advanced technology, and innovative practices; and the extent to which the electric utility has advanced state policy. We therefore, direct the electric utilities to include this information in their SEET filings.

While a number of commenters request a bright line statistical analysis test for the evaluation of earnings, and the Commission agrees that statistical analysis can be one of many useful tools, utilizing only a statistical method for establishing the SEET threshold is insufficient by itself to meet the electric utility's burden of proof pursuant to Section 4928.143(F), Revised Code. Section 4928.143(F), Revised Code, places on the utility "the burden of proof for demonstrating that significantly excessive earnings did not occur." Passing a statistical test does not, in and of itself, demonstrate that excessive earnings did not occur. The statute requires more from the utilities to meet the burden of proof that excess earnings did not occur. The Commission may use a standard deviation test as one tool by which to determine whether an electric utility had significantly excessive earnings.

However, the Commission is willing to recognize a "safe harbor"of 200 basis points above the mean of the comparable group. To that end, any electric utility earning less than 200 basis points above the mean of the comparable group will be found not to have significantly excessive earnings.

<u>Staff Recommendation 8: What does "in the aggregate" mean in relation to the adjustments resulting in significantly excessive earnings?</u>

Staff interprets "in the aggregate" in relation to the adjustments resulting in significantly excess earnings to mean that the total of all the adjustments created by the implementation of an ESP is to be assessed for its impact in determining whether the electric utility achieved a return on common equity significantly in excess of the earnings of comparable companies.

Customer Parties cite the language in Section 4928.143(F), Revised Code, in support of their arguments that: (1) an electric utility's SEET refund exposure is limited to the aggregate amount of the ESP rate adjustment the electric utility receives, and excludes any excess earnings which resulted from something other than the ESP; and (2) the cumulative level of the ESP rate adjustment is subject to refund (Customer Parties Initial at 18). FirstEnergy, AEP-Ohio, and Duke argue that the Customer Parties' concept that "in the aggregate" is also "cumulative" is unsupported and inconsistent with the statutory directive of applying the SEET annually based on the language in Section 4928.143(F), Revised Code, and modifies the General Assembly's design for SEET (FirstEnergy Reply at 10; AEP-Ohio Reply at 1-2; Duke Reply at 8). Further, AEP-Ohio argues that the inherent flaw in Customer Parties' argument is that the earnings from the first year of an ESP would be subject to refund in every year of the term of the ESP, but adjustments made in the first year are not considered in subsequent years. The initial adjustment, AEP-Ohio rationalizes, becomes a part of the base rate level for the next year. Therefore, AEP-Ohio emphasizes that the proposal could result in returning to consumers 2009 earnings in 2011, or later, depending on the term of the ESP. (AEP-Ohio Reply at 14.)

AEP-Ohio concurs with the Staff recommendation (AEP-Ohio Initial at 11). Duke asserts that the Staff's proposal is unclear and requests clarification (Duke Initial at 6-7). DP&L contends that pursuant to Section 4928.143(E) and (F), Revised Code, and the intent of SB 221, the SEET only applies to the adjustments made by the ESP. DP&L believes that the components of an electric utility's standard service offer, approved by the Commission prior to the ESP, are not subject to the SEET, as supported by the company's interpretation of the legislation's Final Analysis. DP&L points out that the legislature's Final Analysis of SB 221 specifically states: "the PUCO must determine if any price adjustments granted under the plan resulted in excessive earnings for the utility" and only if "the adjustments, in the aggregate, did result in significantly excessive earnings, it must require the utility to return to consumers the amount of the excess by prospective adjustments," subject to the electric utility's right to terminate the ESP and file an MRO immediately. DP&L asserts that the legislative analysis clearly provides that the SEET applies only to ESP-created adjustments to the standard service offer and, therefore, reasons that the phrase "in the aggregate" means that the adjustments to the standard offer should be looked at together, and not by each individual component. (DP&L Initial at 5-6.)

The Commission finds that "in the aggregate" refers to the total of any adjustments resulting from the ESP as advocated by Staff. In addition, we do not equate the phrase "in the aggregate" to mean "cumulative" as Customer Parties argue. The Commission reasons that to make the adjustments resulting in significantly excessive earnings cumulative would, as AEP-Ohio argues, make the electric utility's earnings from the first year of an ESP subject to refund in every year of the term of the ESP without consideration of the adjustments made in the first year being considered in subsequent years. Furthermore, as previously explained in response to Recommendations 3 and 11, the Commission finds that the amount of adjustments eligible for refund will be the value of the adjustments in the current year under review compared to the revenues which would have been collected had the rates from the electric utility's previous rate plan still been in place. For these reasons, we adopt the recommendation of the Staff as to the meaning of "in the aggregate."

Staff Recommendation 10: What mechanism should be employed to return to customers the amount of excess earnings?

Staff recommends that the Commission determine in each electric utility's annual SEET proceeding the mechanism by which any excess earnings may be returned to customers. This would allow the Commission the discretion, based on any unique situation or time sensitive circumstance, to return the money to customers as the Commission believes appropriate. The Commission would also have the latitude to return the money in varying time periods and/or as reductions to other electric utility-imposed charges as the Commission deems appropriate.

Customer Parties generally concur with the Staff recommendation, but only to the extent that "other EDU imposed charges" means charges affecting customer rates and, thus, a reduction of such charges results in a reduction in customer rates. Customer Parties contend that after a finding of significantly excessive earnings, the parties should endeavor to stipulate to the mechanism to return the excess earnings to customers and, if a stipulation cannot be achieved, the parties should be provided an opportunity to present their respective position to the Commission. Customer Parties contend that SEET refunds may raise a number of issues better addressed as a part of the circumstances of any given case.[22] Finally, Customer Parties express some concern with the recommendation regarding the Commission's discretion to refund over varying time periods. Customer Parties argue that customers should get any excess earnings refund as promptly as possible without delay. (Customer Parties Initial at 23.)

AEP-Ohio, DP&L, and FirstEnergy agree with Staff's recommendation that the prospective adjustments should be determined on a case-by-case basis. DP&L, however, emphasizes that Section 4928.143(E) and (F), Revised Code, does not characterize the

---

22 Customer Parties state, for example, that a SEET proceeding may raise the following issues: (1) Should a SEET refund be bypassable or non-bypassable credit; (2) Over what period of time should the refund be made; (3) Should there be interest on the unamortized SEET refund balance and, if so, at what level; (4) Should a customer on discounted economic development contract (reasonable arrangement or unique arrangement) receive an additional discount through a SEET refund; and (5) Should any SEET refund first be used to pay off monies owed by customers to the electric utility in the form of deferrals.

adjustments as "refunds" and, therefore, proffers that any prospective adjustments from the SEET represent prospective changes in charges associated with providing future electric services. AEP-Ohio contends that the case-by-case determination should be addressed by the parties after a Commission determination of significantly excessive earnings. This two-step process would enable parties to a proceeding to consider the appropriate mechanism in the context of the amount of the significantly excessive earnings. (DP&L Initial at 6; AEP-Ohio Initial at 11; AEP-Ohio Reply at 14-15; FirstEnergy Initial at 7.)

As each of the commenters recognizes, if an electric utility is found to have significantly excessive earnings, such a determination has the potential to raise several issues, which are better addressed on a case-by-case basis. For that reason, the Commission may offer the parties to a SEET proceeding a reasonable, limited period of time to propose how any excess earnings should be returned to customers, including any buy-down of deferrals.

ORDER:

It is, therefore,

ORDERED, That pursuant to the decisions of the Commission as set forth herein, each electric utility's earnings be evaluated in accordance with this Order. It is further,

ORDERED, That Citizen's request to withdraw its initial comments and adopt the position of Customer Parties in its initial and reply comments be granted. It is, further,

ORDERED, That each electric utility file its proposed SEET application, in accordance with the Commission's directives, by July 15, 2010. It is, further, ORDERED, That a copy of this entry be served upon all commenters, electric distribution companies and electric service companies operating in Ohio, and all other interested persons of record.

THE PUBLIC UTILITIES COMMISSION OF OHIO

Alan R. Schriber, Chairman

Paul A. Centolella

Valerie A. Lemmie

Steven D. Lesser

Cheryl L. Roberto

GNS/ vrm

Entered in the Journal
JUN 3 0 2010

Reneé J. Jenkins
Secretary