

**FILE**

21

**BEFORE  
THE PUBLIC UTILITIES COMMISSION OF OHIO**

In the Matter of the Fuel Adjustment Clauses  
for Columbus Southern Power Company and  
Ohio Power Company

) Case No. 09-872-EL-FAC  
) Case No. 09-873-EL-FAC  
)

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**PUBLIC VERSION**

**DIRECT TESTIMONY OF J. EDWARD HESS  
ON BEHALF OF INDUSTRIAL ENERGY USERS-OHIO**

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**August 16, 2010**

**Attorneys for Industrial Energy Users-Ohio**

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**INDEX**

**Page No.**

I.	INTRODUCTION AND OVERVIEW OF RECOMMENDATIONS .....	1
II.	██ CONTRACT BUYOUT .....	3
III.	████████████████████ CONTRACT SUPPORT .....	9

**CERTIFICATE OF SERVICE**

**EXHIBITS**

JEH-1 – Responses to IEU-Ohio Interrogatories 1-001, 1-003, 1-005, First Set  
JEH-2 – Response to IEU-Ohio Interrogatory INT-01, Second Set  
JEH-3 – Response to IEU-Ohio Interrogatory 1-013  
JEH-4 – Response to IEU-Ohio Interrogatory 1-013, Confidential Attachment 1

**BEFORE  
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**PUBLIC VERSION**

**DIRECT TESTIMONY OF J. EDWARD HESS  
ON BEHALF OF INDUSTRIAL ENERGY USERS-OHIO**

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**1 I. INTRODUCTION**

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

**3 A1. J. Edward Hess, 21 East State Street, 17<sup>th</sup> Floor, Columbus, Ohio 43215.**

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

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

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

**11 A3. I received a Bachelors of Business Administration degree from Ohio University in**  
**12 1975 majoring in accounting. I completed the majority of Capital University's**  
**13 Master of Business Administration program and I have completed many**  
**14 regulatory training programs. I am a certified public accountant.**

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

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

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

A5. I have testified numerous times before this Commission, beginning in the early 1980's, as part of my responsibilities as a Commission employee.

**Q6. What is the purpose of your testimony?**

A6. My testimony contains recommendations that I have developed for the purpose of aligning the costs that are eligible for recovery through the Fuel Adjustment Clause ("FAC") and the benefits associated with such costs. My recommendations focus on two items identified by Energy Ventures Analysis, Inc. ("EVA") in the Audit Report for Columbus Southern Power Company ("CSP") and Ohio Power Company ("OP") (collectively, "American Electric Power-Ohio" or "AEP-Ohio"), docketed May 14, 2010. More specifically:

- I recommend that the Commission either credit the following three items against OP's deferred fuel expense which is subject to future recovery (1) the

1 total value of the [REDACTED], (2) the correct value of the real  
2 property interests [REDACTED]  
3 [REDACTED], (3) and the [REDACTED]  
4 American Electric Power Service Corporation ("AEPSC") in [REDACTED]  
5 resulting from the [REDACTED] contract  
6 buyout; or direct OP to re-price the FAC recovery mechanism to reflect the  
7 original [REDACTED] [REDACTED]  
8 [REDACTED].

- 9 • I recommend that the \$[REDACTED] per ton addition to the contract price for the  
10 [REDACTED]  
11 [REDACTED]  
12 [REDACTED]. The Commission should require [REDACTED] to refund the FAC portion of  
13 the \$[REDACTED] per ton addition already collected from [REDACTED] customers.

## 14 II. [REDACTED] CONTRACT BUYOUT

15 **Q7. Will you describe your understanding of the [REDACTED] contract buyout?**

16 **A7.** Yes, my understanding is based on the information that is contained within the  
17 EVA audit report, discussions with the auditor, discussions with representatives  
18 of OP and CSP, and the responses we received to our discovery requests.

19  
20 In [REDACTED], OP and [REDACTED] entered into a [REDACTED] contract for the supply of coal  
21 for the [REDACTED]. By 2007, the price for delivered coal under  
22 the contract was significantly below prevailing market prices for comparable coal.  
23 A dispute over the contract arose that the parties resolved through negotiations.

1 As a result of the negotiations, OP and [REDACTED] agreed to terminate the contract  
2 at the end of 2008 rather than allowing it to continue through the [REDACTED] contract  
3 period. As a result of this early termination of the contact, [REDACTED]  
4 [REDACTED]. EVA notes  
5 that the buyout caused OP ratepayers to pay approximately \$[REDACTED] more for  
6 coal during 2009 than they would have paid if OP had continued to receive coal  
7 at the price agreed to by [REDACTED].<sup>1</sup>

8  
9 As part of the negotiated agreement, [REDACTED]  
10 [REDACTED] and AEPSC received [REDACTED]  
11 [REDACTED], the value of the [REDACTED] Reserve, and [REDACTED]  
12 [REDACTED]. AEPSC booked the value of the [REDACTED] Reserve as \$[REDACTED] million.  
13 EVA's audit report indicated [REDACTED]  
14 [REDACTED].<sup>2</sup> EVA recommended that the Commission consider whether it would be  
15 appropriate to credit the [REDACTED] and a [REDACTED] for the  
16 [REDACTED] Reserve against OP's deferred fuel expense.

17 **Q8. What is your understanding of the valuation of the [REDACTED] Reserve?**

18 **A8.** AEPSC commissioned [REDACTED] to perform a mine  
19 feasibility study of the [REDACTED] Reserve. [REDACTED] [REDACTED]

<sup>1</sup> Audit Report at 1-5.

<sup>2</sup> Audit Report at 2-21.

1 [REDACTED]  
2 [REDACTED]  
3 [REDACTED]  
4 [REDACTED]  
5 [REDACTED]  
6 [REDACTED]

7 **Q9. How did AEPSC account for the [REDACTED] and the value of the**  
8 **[REDACTED] Reserve?**

9 **A9. The [REDACTED] and [REDACTED] Reserve valuation**  
10 **[REDACTED] were [REDACTED]**  
11 **[REDACTED]. The [REDACTED]**  
12 **[REDACTED]**  
13 **[REDACTED]**<sup>3</sup>

14  
15 **Q10. How was the [REDACTED] from [REDACTED] accounted for?**

16 **A10. In [REDACTED], OP recorded this contract settlement by [REDACTED]**  
17 **[REDACTED]**  
18 **[REDACTED]**<sup>4</sup> **[REDACTED]**  
19 **[REDACTED] increase earnings.**

20 **Q11. Did OP FAC customers receive the full benefit of the [REDACTED] negotiation?**

21 **A11. No. The current accounting implemented by AEPSC would have FAC customers**  
22 **bear the total costs of the negotiation while AEPSC and OP are allowed to retain**

<sup>3</sup> Response to IEU-Ohio Interrogatories 1-001, 1-003, 1-005, First Set. (Exhibit JEH-1).  
<sup>4</sup> Response to IEU-Ohio Interrogatory INT-01, Second Set. (Exhibit JEH-2).

1 a majority of the benefits. This is because of the two different mechanisms in  
2 place during 2008 and 2009 to recover fuel costs. [REDACTED]

3 [REDACTED]  
4 [REDACTED]  
5 [REDACTED]  
6 However, during 2008 OP did not have a specific fuel cost recovery mechanism  
7 to flow through these benefits to OP customers. Therefore, the [REDACTED]  
8 [REDACTED] in benefits flowed through to earnings. The  
9 result of this accounting is that during 2009 and through 2011, the FAC recovery  
10 mechanism, created as part of OP's Electric Security Plan ("ESP"), will flow the  
11 higher costs of fuel obtained through renegotiated coal contracts directly to  
12 customers but only recognize a portion of the [REDACTED]  
13 [REDACTED]. As noted earlier in this testimony, EVA has estimated that  
14 OP ratepayers paid approximately \$[REDACTED] million more for coal during 2009 than  
15 they would have paid if OP had continued to receive coal at the price agreed to  
16 by [REDACTED].

17 **Q12. Do you agree with EVA's recommendation that the Commission should**  
18 **require OP to credit [REDACTED] and the true value of the [REDACTED]**  
19 **Reserve against OP's deferred fuel expense?**

20 **A12.** Yes, that is only one of the options that the Commission should consider to  
21 match these particular costs and benefits. OP customers experienced higher  
22 fuel costs during 2009 as a result of the [REDACTED] contract termination. As  
23 explained above, AEPSC's accounting subjects customers to higher costs as a



1 result of AEPSC's agreement to [REDACTED] and  
2 AEPSC failed to [REDACTED]. It is my view  
3 that AEPSC's accounting violates the ratemaking principle that aligns the costs  
4 recoverable through rates with the benefits associated with such costs. Crediting  
5 [REDACTED], the value of the [REDACTED] Reserve, and [REDACTED]  
6 [REDACTED] against the expense eligible for recovery through the FAC or the  
7 deferral is one fair and reasonable way to account for the totality of the  
8 negotiation.

9 **Q13. If the Commission adopts this option of matching costs and benefits, what**  
10 **would you recommend for the valuation of the [REDACTED] Reserve?**

11 A13. I believe that the valuation of the [REDACTED] Reserve needs further investigation.  
12 The 2010 FAC recoveries are subject to another annual audit and the deferred  
13 fuel expense for OP will not begin to be recovered until 2012. There is time to  
14 develop a reliable estimate of the value of the [REDACTED] Reserve and incorporate  
15 this value in the final determination of the balance that may be subject to  
16 recovery beginning in 2012. I recommend that the Commission [REDACTED]  
17 [REDACTED] to make the initial adjustment but that the Commission  
18 require the 2010 FAC auditor to investigate the valuation in its next audit and that  
19 the auditor include a recommended valuation in the next audit report.

20 **Q14. You have testified that the approach recommended by EVA is one option to**  
21 **match costs and benefits. What other option is available to align the**  
22 **benefits and the costs?**

1 A14. As explained above, had the [REDACTED] as a result of the  
2 negotiations, the annual costs recoverable through the FAC would have been  
3 about \$ [REDACTED] million less. The second option would be to use the [REDACTED] contract  
4 to value the level of cost eligible for recovery through the FAC [REDACTED]  
5 [REDACTED]  
6 [REDACTED]. Under this option, OP would retain the value of the benefits received  
7 from [REDACTED] in exchange for the agreement [REDACTED]  
8 [REDACTED]  
9 [REDACTED] This second option may be more attractive from an  
10 administrative perspective since it does not require either a future auditor or the  
11 Commission to make a subsequent determination of the value of the [REDACTED]  
12 Reserve. If the Commission believes that avoiding subsequent issues related to  
13 the value of the [REDACTED] Reserve is appropriate, the Commission should direct  
14 OP to adjust the FAC recovery mechanism to re-price the coal subject [REDACTED]  
15 [REDACTED] from the [REDACTED]  
16 [REDACTED] at the [REDACTED] contract price. To offset the  
17 re-pricing, the Commission could allow AEPSC to retain the value obtained from  
18 [REDACTED] by not reducing the deferred fuel expense by the amount of such value.

19 **Q15. What is your recommendation for the Commission?**

20 A15. I recommend that the [REDACTED], the total value of the  
21 [REDACTED] Reserve, and the [REDACTED] be utilized to reduce the  
22 OP deferred fuel expense. The FAC mechanism approved by the Commission  
23 has resulted in accumulated deferred fuel expense for OP totaling \$310,549,298

1 through December 31, 2009.<sup>5</sup> This deferral is a byproduct of the limitations that  
2 the Commission inserted into OP's ESP. If adopted, this recommendation would  
3 operate to reduce the deferred fuel expense balance. This would require the  
4 Commission to order OP to reduce the deferral by [REDACTED]  
5 [REDACTED] plus any additional value that the Commission finds for the [REDACTED]  
6 Reserve above the [REDACTED]. The reduction should also include any carrying  
7 costs that have accrued on this adjustment.

8  
9 If the Commission judges that it would be appropriate to avoid future issues  
10 related to the value of the [REDACTED] Reserve, I recommend that the Commission  
11 order OP to adjust the FAC recovery mechanism to re-price the coal subject to  
12 the [REDACTED] from the [REDACTED]  
13 contract at the [REDACTED] and allow AEPSC to retain the value  
14 of [REDACTED], the value of the [REDACTED] Reserve, and [REDACTED]  
15 [REDACTED].

16 **III. [REDACTED] CONTRACT SUPPORT**

17 **Q16. Will you describe your understanding of the [REDACTED] contract support?**

18 **A16.** Yes, my understanding is based on the information that is contained within the  
19 EVA audit report, discussions with the auditor, discussions with representatives  
20 of OP and CSP, and the responses we received to our discovery requests.  
21

---

<sup>5</sup> Audit Report at page 7-32.

1 In 2008, ██████ asserted that it was losing money under its contract and if no  
2 relief was provided it would not meet its financial covenants. In response,  
3 AEPSC agreed to a two-prong financial package for ██████. AEPSC agreed to  
4 ██████ in September 2008 and ██████ agreed to repay  
5 AEPSC by deducting ██████ tons beginning in 2009. AEPSC  
6 also agreed to increase the base price for the ██████  
7 ██████/ton effective for ██████. The contract was also amended to  
8 provide AEPSC with the right to extend the contract for two three-year periods at  
9 the agreed-upon market price less ██████/ton. ██████  
10 ██████  
11 ██████<sup>6</sup>

12  
13 EVA observed that AEPSC's actions related to ██████ were "carefully considered  
14 and economically evaluated." EVA also cited the history of AEPSC's relationship  
15 with ██████ and the importance of retaining ██████ as a supplier for ██████  
16 ██████.

17 **Q17. Was the increased base price of \$█████/ton for the ██████**  
18 **█████, which AEPSC agreed to, recovered through the FAC during 2009?**

19 **A17. Yes. The increased base price of \$█████/ton for ██████**  
20 **was recovered through the FAC during 2009. The total amount recovered by**  
21 **█████ in 2009 was \$█████. The \$█████ is the ██████**

---

<sup>6</sup> Response to IEU-Ohio Interrogatory 1-013. (Exhibit JEH-3).

1 [REDACTED]

2 [REDACTED] of \$ [REDACTED].<sup>7</sup>

4 [REDACTED]

5 [REDACTED]

6 [REDACTED]

7 **Q18. Do you believe that AEPSC's accounting associated with the [REDACTED] price**  
8 **increase and subsequent [REDACTED] is appropriate for ratemaking purposes?**

9 **A18. No. The current FAC recovery mechanism only extends through 2011 assuming**  
10 **the current ESP is not terminated sooner. AEPSC's accounting essentially [REDACTED]**

11 [REDACTED]

12 [REDACTED]. This improperly  
13 aligns the costs it is recovering from customers with the benefits.

14 **Q19. How should the accommodation between [REDACTED] and AEPSC be reflected**  
15 **in the accounting for the FAC?**

16 **A19. I recommend that the Commission require [REDACTED] to refund the \$ [REDACTED]/ton**

17 [REDACTED]

18 [REDACTED]

19 [REDACTED]

20 [REDACTED] This would match the benefits of the  
21 accommodation with the cost.

---

<sup>7</sup> Response to IEU-Ohio 1-013, Confidential Attachment 1. (Exhibit JEH-4).

1 Q20. Do you believe that a carrying cost should be added to the deferred  
2 expense?

3 A20. No. [REDACTED]

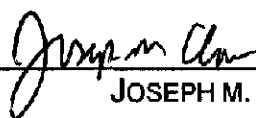
4 [REDACTED] However, if the Commission believes that a carrying cost is  
5 necessary, the carrying cost rate should be a debt only rate consistent with  
6 several of the other carrying cost rates recently approved by the Commission.

7 Q21. Does this conclude your testimony?

8 A21. Yes.

## **CERTIFICATE OF SERVICE**

I hereby certify that a copy of the foregoing *Public Version of Direct Testimony of J. Edward Hess* was served upon the following parties of record this 16th day of August 2010, via electronic transmission, hand-delivery or first class mail, postage prepaid.



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**ON BEHALF OF THE PUBLIC UTILITIES  
COMMISSION OF OHIO**

**IEU-OHIO'S INTERROGATORIES PROPOUNDED UPON  
COLUMBUS SOUTHERN POWER COMPANY  
AND OHIO POWER COMPANY  
CASE NO. 09-872-EL-FAC  
FIRST SET**

**INTERROGATORIES**

1-001. Please provide a description and the journal entries of how American Electric Power Service Company ("AEPSC") accounted for the [REDACTED] made by [REDACTED], as described on page 2-21 of the Audit Report.

**RESPONSE**

The [REDACTED] received by Ohio Power Company (OPCo) from [REDACTED] and [REDACTED] were part of a settlement agreement executed [REDACTED] and AEPSC, as agent for OPCo. As part of this settlement agreement, OPCo [REDACTED] and also mineral and real property interests [REDACTED].

In [REDACTED], OPCo recorded [REDACTED] the [REDACTED] Reserve [REDACTED] as a [REDACTED].

Please see Confidential Attachment IEU, 1-001.xls for these journal entries.



Confidential Attachment IEU 1-001.pdf



**IEU-OHIO'S INTERROGATORIES PROPOUNDED UPON  
COLUMBUS SOUTHERN POWER COMPANY  
AND OHIO POWER COMPANY  
CASE NO. 09-872-EL-FAC  
FIRST SET**

**INTERROGATORIES**

1-003. If the answer to Interrogatory #2 is affirmative, please [REDACTED]  
[REDACTED] and supporting calculations for the [REDACTED]  
[REDACTED] that were included in the 2009 FAC for [REDACTED].

**RESPONSE**

[REDACTED]  
[REDACTED] be subject to the 2009 FAC. Please see **Confidential**  
**Attachment EIU, 1-003.xls** for monthly detail.



Confidential Attachment IEU 1-003.pdf

**IEU-OHIO'S INTERROGATORIES PROPOUNDED UPON  
COLUMBUS SOUTHERN POWER COMPANY  
AND OHIO POWER COMPANY  
CASE NO. 09-872-EL-FAC  
FIRST SET**

**INTERROGATORIES**

1-005. If the answer to Interrogatory #4 is affirmative, please identify [REDACTED]  
[REDACTED] and supporting calculations for the [REDACTED]  
[REDACTED] that AEPSC plans to include in the 2010 FAC for [REDACTED].

**RESPONSE**

In [REDACTED], OPCo [REDACTED],  
a [REDACTED]

[REDACTED]. This amount is [REDACTED]  
[REDACTED] in [REDACTED], and is [REDACTED] from the [REDACTED].

Please see **Confidential Attachment EIU, 1-003.xls** in response to EIU, 1-003 for supporting calculations.

CONFIDENTIAL VERSION

IEU-OHIO'S INTERROGATORIES PROPOUNDED UPON  
COLUMBUS SOUTHERN POWER COMPANY  
AND OHIO POWER COMPANY  
CASE NO. 09-872-EL-FAC  
SECOND SET-CONFIDENTIAL VERSION

INTERROGATORIES

INT-01 Please provide a description and the journal entries of how American Electric Power Service Company ("AEPSC") accounted for the [REDACTED] by AEPSC to [REDACTED], described on page 2-21 of the Audit Report, which was [REDACTED] on [REDACTED] and [REDACTED] and [REDACTED]

RESPONSE

In [REDACTED] AEPSC, on behalf of OPCo, [REDACTED] upon [REDACTED] In [REDACTED] OPCo recorded this contract settlement by [REDACTED] and [REDACTED] and [REDACTED]

Please see Attachment IEU, 2-1 for applicable journal activity for [REDACTED]



Attachment IEU 2-1.xls

**IEU-OHIO'S INTERROGATORIES PROPOUNDED UPON  
COLUMBUS SOUTHERN POWER COMPANY  
AND OHIO POWER COMPANY  
CASE NO. 09-872-EL-FAC  
FIRST SET**

**INTERROGATORIES**

1-013. On [REDACTED] of the Audit Report, EVA reports that AEPSC agreed to increase the base price for all coal [REDACTED] effective January 1, 2009. Please provide what portion of the incremental cost of the \$ [REDACTED]/ton for coal [REDACTED] during [REDACTED] was recovered or deferred through the 2009 FAC [REDACTED]?

**RESPONSE**

While EVA understood the overall nature of the [REDACTED], [REDACTED] of EVA's audit report contains a few points that could be clarified. We submit the following for clarification:

For the [REDACTED]

[REDACTED] agreed to [REDACTED]

\$ [REDACTED]

agreed [REDACTED]

Whereas the audit report states that [REDACTED]

by [REDACTED]

[REDACTED] in 2009.

In addition, AEPSC agreed to [REDACTED]

to [REDACTED]

The impact of the [REDACTED] in [REDACTED] to the FAC is approximately \$ [REDACTED]. Please see IEU 1-013 Confidential Attachment 1 for the workpapers supporting this figure.



Confidential Attachment IEU 1-013.pdf

Schedule to approximate FAC share of coal inventory changes

