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BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

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

POST-HEARING BRIEF ON REMAND BY THE OFFICE OF THE OHIO CONSUMERS' COUNSEL AND OHIO PARTNERS FOR AFFORDABLE ENERGY

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I. INTRODUCTION

Nearly 1.4 million customers of Columbus Southern Power Company ("CSP") and Ohio Power Company ("OP") (collectively, "AEP Ohio" or "Companies") have paid more than a half a billion dollars[1] in increased rates since April 2009, in support of, among other things, the provider of last resort ("POLR") charge and carrying charges on environmental investment made pre-2009. These charges, though initially approved by the Public Utilities Commission of Ohio ("PUCO" or "Commission") in its March 18,

[1] It is estimated that AEP Ohio's customers will have paid about $787 million in POLR and carrying charges on pre-2009 environmental investments over the three year term of the first ESP. From April 2009 to May 2011, the customers have paid $634 million in these two charges to AEP Ohio. See OCC Remand Ex. 2, Attachment DJD-E. Rates being collected subject to refund amount to approximately $153 million. See OCC Remand Ex. 2, Attachment DJD-D.

2009 Opinion and Order, were subsequently determined by the Ohio Supreme Court to be unjustified.[2]

The Supreme Court's Order reversed the PUCO and remanded these matters back to the PUCO. The Court opined that the Commission *may* revisit the matters, but admonished the Commission (at least with respect to POLR) that the PUCO "should explain its rationale, respond to contrary positions, and support its decision with appropriate evidence."[3]

The PUCO has permitted the Companies the opportunity to advance arguments to support the collection of these rate elements, and in turn has permitted parties to challenge the evidence put forth by the Companies.[4] Whether the unjustified charges that were and are being collected from customers will be returned to customers, in part, or in whole, is now the ultimate determination that must be made by the PUCO.

In this regard, the Office of the Ohio Consumers' Counsel ("OCC"), on behalf of the residential customers of the Companies, and Ohio Partners for Affordable Energy ("OPAE"), on behalf of the low-income residential customers of the Companies, urge the PUCO should protect customers from unjustified rate increases during the remainder of 2011 by ordering that approximately $153 million in charges, presently being collected subject to refund, be completely returned to customers with interest.[5] The Companies' rates for the remainder of 2011 should be set without the unjustified elements for POLR and

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[2] The Court, on April 19, 2011 issued a decision on the appeal by the Office of the Ohio Consumers' Counsel and the Industrial Energy Users – Ohio ("IEU")[2] from this Commission's March 18, 2009 Opinion and Order). *In re Application of Columbus Southern Power Company, et al.*, 2011 Ohio 1788.

[3] Id. at ¶30.

[4] See Entry at 4 (May 25, 2011).

[5] See OCC Remand Ex. 2 at 11-12 and 29-30 (Duann testimony that the POLR charge and environmental carrying charge being collected, subject to refund, should be returned in its entirety to customers). The refund should be approximately $153 million. OCC Remand Ex. 2 at Attachment DJD-D. An interest rate of 10.93% should be applied to calculate the refund. OCC Remand Ex. 2 at 11-12 and 29-30.

carrying charges on environmental investment made before 2009. Additionally, with respect to the phase-in deferrals to be collected from customers during 2012 through 2018, the PUCO should lower those prospective charges by approximately $633 million.[6] Doing so will recognize that by charging customers for unjustified POLR and environmental expenses since April 2009, the Commission permitted regulatory assets to be created that were unfounded in law and overvalued. These overvalued regulatory assets created unreasonable deferrals, which should be adjusted prospectively to prevent over-collecting unlawful expenses from customers starting in 2012.

II. APPLICABLE LAW

Ohio's recently enacted legislation regarding the regulation of electric utilities, Sub. S.B. 221 ("S.B. 221"), significantly altered R.C. Chapter 4928. The Commission aptly described the revised Chapter 4928 of the Revised Code as providing a roadmap of regulation in which specific provisions were put forth to advance state policies of ensuring access to adequate, reliable, and reasonably priced electric service in the context of significant economic and environmental challenges.[7] The state policies to which the Commission was referring were among the 14 objectives listed in R.C. 4928.02 -- objectives that have remained largely in place since 1999. Included within the state policies are provisions:

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[6] See OCC Remand Ex. 2, Attachment DJD-E.

[7] *In re FirstEnergy MRO Proposal*, Case No. 08-936-EL-SSO, Opinion and Order at 5 (November 25, 2008).

- to ensure customers have available adequate, reliable, safe, efficient, non-discriminatory, and reasonably priced electric service;
- to ensure the availability of unbundled and comparable retail electric service that provides customers with options to meet their needs;
- to ensure diversity of electricity supply and suppliers giving customers choice of retail electric service; and
- to ensure effective competition.

R.C. 4928.06 makes these policies more than a statement of general policy objectives. R.C. 4928.06(A) imposes upon the Commission a specific duty to "'ensure the policy specified in section 4928.02 of the Revised Code is effectuated.'"[8]

In addition to these policies, specific statutory provisions pertain to POLR responsibilities and environmental carrying charges. POLR responsibilities are described and addressed in R.C. 4928.01(A)(1), 4928.14, and. 4928.141. As noted by the Ohio Supreme Court, while these statutes impose a duty on an electric distribution utility to become a POLR,[9] they do not specify a single manner in which such a distribution utility is required to ensure the availability of generation service to customers returning to the standard service offer ("SSO").[10] Environmental carrying charges, if permissible, must be found under subsections of R.C. 4928.143(B)(2). This statute was specifically

[8] Id. at 13.

[9] The Court referred to R.C. 4928.141 through 4928.143. *In re Application of Columbus Southern Power Company, et al.*, 2011 Ohio 1788, ¶5.

[10] Id. at ¶25.

construed by the Ohio Supreme Court as restrictive in nature, permitting plans to include only the enumerated provisions of subsection (B)(2).[11]

III. ARGUMENT

A. The POLR Obligation Must Be Considered In a Manner Consistent with the Objectives of S.B. 221.

Senate Bill 3 ("S.B. 3") instituted restructuring of the Ohio electric industry in order to achieve retail competition for the generation component of electric service.[12] S.B. 3 is the base upon which S.B. 221 builds, with S.B. 221 retaining much of the former S.B. 3, including Ohio's policies as set forth in R.C. 4928.02, the right to shop for generation,[13] and specific provisions containing directives to the PUCO to ensure competitive retail electric service.[14] As recognized by the Companies, the most basic and central premise of S.B. 221 is the development of competitive generation markets for retail customers in Ohio.[15]

In order for competition to develop in Ohio, the PUCO must carefully consider the impact of non-bypassable charges (if any) on competition. AEP Ohio's POLR charge is one such non-bypassable charge,[16] approved by the Commission as a *distribution* charge.[17]

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[11] Id. at ¶31.

[12] *Industrial Energy Users-Ohio v. Public Util. Comm.*, 2008 Ohio 990, ¶¶5-6.

[13] See R.C. 4928.03.

[14] See R.C. 4928.06.

[15] See Companies' Appellant Brief in the Ormet appeal, S.Ct. Case No. 2009-2020, at 28 (January 22, 2010).

[16] The POLR charge is non-bypassable except for customers who agree to return to the service by AEP Ohio at market rates. *In re AEP Ohio's First Electric Security Plan Proposal,* Case Nos. 08-917-EL-SSO et al., Opinion and Order at 40 (March 18, 2009) ("ESP Order").

[17] ESP Order at 38-40 (March 18, 2009).

If AEP Ohio incurs costs associated with the fulfillment of its POLR obligations, the Ohio Supreme Court has duly noted that the PUCO should "carefully consider what costs it is attributing as costs incurred as part of an electric-distribution utility's POLR obligations."[18] Indeed the Court has been careful to restrict costs defined as POLR,[19] has carefully scrutinized the characterization of POLR costs as distribution or generation charges,[20]and has remanded PUCO orders where an electric distribution utility's ("EDU's") proposal on rehearing included POLR components without record support.[21] The common thread in these Supreme Court decisions is the notion that imposing a significant POLR charge, for ill-defined costs, will deter customer choice and the development of retail competition.[22] Thus the Commission must, when defining POLR, and reviewing the alleged costs of POLR, take into account the implications of its findings upon the legislative scheme imposed by the General Assembly. This means that POLR cannot be defined or compensated for in a way that gives the EDU an undue advantage that thwarts the very purpose of S.B. 221.

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[18] *Industrial Energy Users-Ohio v. Public Util. Comm.*, 2008 Ohio 990 ¶27, citing *Ohio Consumers' Counsel v. Public Util. Comm.*, 2007 Ohio 4276, ¶26.

[19] Id. at ¶25-33 (disallowing AEP to collect costs associated with the research and development of a proposed generation facility as a way to fulfill AEP Ohio's POLR obligations).

[20] See *Ohio Consumers' Counsel v. Public Util. Comm.*. 2007 Ohio 4276 at ¶17-26 (expressing concern that the distinction between generation and distribution (with respect to charges argued as 'POLR") may become too blurred to effectively unbundle the components of electric service, as required under S.B. 3, and continued under SB 221).

[21] *Ohio Consumers' Counsel v. Public Util. Comm.* 2006 Ohio 5789 at 22-36.

[22] See for example, Constellation Ex. 2, Direct Testimony of David Fein at 6-12 (October 31, 2008).

B. The POLR Obligation Requires that an EDU Stand Ready to Serve Returning Customers at the SSO Price.

OCC Witness Thompson testified that the Companies' POLR obligation is derived from two statutes, R.C. 4928.141(A) and 4928.14.[23] Taken together these statutes require the Companies to offer standard service to all customers within its service territory and serve as a default provider in the event that a competitive retail electric service supplier ("CRES") fails to provide retail generation service to customers. POLR charges can then be logically construed to relate to costs of obtaining capacity and energy for customers who have shopped and subsequently wish to return to service with the default supplier.[24]

OCC Witness Thompson concluded that POLR is not linked to the right to switch, but rather linked to the need for the EDU to provide SSO service to customers *returning* from a CRES provider.[25] IEU Witness Lesser similarly defines POLR.[26] Staff Witness Cahaan, in the earlier phase of this proceeding, defined POLR as limited to the "return" component as well.[27] Moreover, SSO service provided to customers upon return is the same definition utilized by the Ohio Supreme Court, where in the remand of this case, the Court reiterated that the POLR is an obligation to stand ready to accept returning customers.[28]

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[23] OCC Remand Ex. 1 at 8. The Companies agree. See Companies' Initial Post Hearing Brief at 41 (December 30, 2008).

[24] See Constellation Ex. 2, Direct Testimony of David Fein at 10 (October 31, 2008).

[25] OCC Remand Ex. 1 at 9.

[26] IEU Remand Ex. 1 at 4.

[27] OCC Remand Ex. 1 at 10, citing to Tr. Vol. XIII at 55-56 (December 5, 2008) (Cahaan). Staff stated that customer departures "are more properly a migration risk, not a POLR risk." Staff Brief at 15-16 (December 30, 2008).

[28] *In re Application of Columbus Southern Power Company, et al.*, 2011 Ohio 1788, ¶23.

This definition of POLR excludes what has been termed "migration risk" --that is that the customer exercises the choice to select a CRES provider and leaves the Companies. As Messrs. Thompson, Lesser, and Cahaan have testified, the ability of customers to switch and pursue their choice of generation supply is a business risk faced by EDUs and CRES providers alike under S.B. 221.[29]

Indeed the PUCO itself has similarly defined POLR as recently as 2006. In the AEP Ohio *IGCC* case,[30] the Commission ruled that POLR is a "distribution ancillary service" under R.C. 4928.03. R.C. 4928.03 refers to the functions necessary to provide transmission or distribution services and includes "back-up supply service."[31] The POLR function invokes back up supply service, whereby the EDU "must have *capacity* available ancillary to the provision of the distribution service."[32]

Defining POLR to include the risk of customer migration, as proposed by AEP Ohio Witness Thomas,[33] would compensate AEP Ohio for a business risk, and thus, creates an undue advantage for AEP Ohio vis-a-vis the CRES providers, affording AEP Ohio "lost revenues" for lost opportunity sales. Such an advantage is detrimental to establishing a competitive market for electric service, the main premise of S.B. 221. The

[29] OCC Remand Ex. 1 at 9; IEU Remand Ex. 1 at 4; Tr. Vol. XIII at 55-56. See also Tr. Vol. VI at 213 (November 24, 2008), where OCC Witness Medine pointed out that the so called migration risk constitutes nothing more than the Company's obligation to serve and should not result in collection of millions of dollars from customers. See also Tr. Vol. VI at 220-221 where Witness Medine testified: "[A}gain, I don't accept the fact that the obligation to serve is equal to a POLR risk. So the obligation to serve—with obligation to serve comes lots of other advantages to the utility, like the reimbursement of their fuel costs during good times and bad times and a number of other benefits.".

[30] *In re AEP Ohio's IGCC Proposal*, Case No. 05-376-EL-UNC.

[31] Id. Opinion and Order at 18 (April 10, 2006).

[32] Id.

[33] See Companies' Remand Ex 4 at 3.

PUCO should reject that approach because otherwise it is thwarting the General Assembly's plan for competitive retail electric service.

By limiting the costs of POLR to no more than the costs of obtaining electric power and energy for those who have shopped and returned to the SSO, the Commission would be correctly construing POLR costs in a manner that is consistent with a pro-choice environment. It would ensure that the Companies can recover actual costs of providing default SSO service under the law while at the same time ensure that competitive generation is allowed to develop to the fullest extent possible. This definition would also be in keeping with the Ohio Supreme Court's admonition that the PUCO should "carefully consider what costs it is attributing as costs incurred as part of an electric-distribution utility's POLR obligations."[34]

C. The Costs of POLR Should be Limited to Those Out of Pocket Costs for Energy and Capacity Necessary to Serve Returning Customers.

Not only must the Commission limit the POLR to costs associated with the return of customers to the EDU's SSO, but it should also limit POLR costs to actual, verifiable, out of pocket costs AEP Ohio actually incurs to serve the returning load. Such costs would encompass incremental energy and capacity costs due to incremental increases in load associated with a returning customer.[35] These costs are verifiable, concrete, and auditable. The same cannot be said for the Companies' defined POLR costs –which amount to, plain and simple, lost revenues.

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[34] *Industrial Energy Users-Ohio v. Public Util. Comm.*, 2008 Ohio 990 ¶27, citing *Ohio Consumers' Counsel v. Public Util. Comm.*, 2007 Ohio 4276, ¶26.

[35] OCC Remand Ex. 1 at 12 (Thompson).

1. POLR, as a monopoly distribution service, must be priced according to R.C. 4909 and 4905. It cannot be priced based on the value of the optionality provided to customers.

In the first portion of this proceeding, the PUCO approved a POLR charge to be collected from customers as a *distribution cost*, to be collected through a *distribution* rider. The Commission's approval of POLR as a distribution service follows the Commission's determination in the IGCC[36] case that recognized POLR as a distribution related service.[37] There the Commission found that then-existing S.B. 3 contemplated that the EDU would provide "ancillary service"[38] as it pertains to POLR.

Distribution ancillary services are subject to Commission regulation, as being necessary to support the distribution function. It is the PUCO's obligation to assure reliable distribution service under R.C. 4928.02(A), and noncompetitive retail electric services are subject to regulation under R.C. 4928.05(A)(2). Noncompetitive retail electric services are defined as components of retail electric service which have neither been declared competitive by the PUCO or by statute.

Ancillary service is not listed as a competitive service under R.C. 4928.03. And although it is included in the list of components which could be declared competitive by the PUCO, it has not been declared competitive.[39] Since ancillary service meets neither

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[36] *In re AEP Ohio's IGCC Proposal*, Case No. 05-376-EL-UNC.

[37] Id., Opinion and Order at 17 (April 10, 2006).

[38] "Ancillary service" is defined under R.C. 4928.01(A)(1) to mean "any function necessary to the provision of electric transmission or distribution service to a retail customer and includes, but is not limited to, scheduling, system control, and dispatch services; reactive supply from generation resources and voltage control service; reactive supply from transmission resources service; regulation service; frequency response service; energy imbalance service; operating reserve supplemental reserve service; load following; *back-up supply service* , real power loss replacement service; dynamic scheduling; system black start capability; and network stability service." (emphasis added).

[39] See R.C. 4928.05(A).

test for being competitive, it is a noncompetitive retail electric service subject to the continuing regulation of the Commission under R.C. 4928.01(B).

Under R.C. 4828.15 rates for such noncompetitive retail electric service must be established in accordance with the provisions set forth in R.C. Chapters 4905 and 4909, the provisions of the code that pertain to monopoly provided service. POLR, the Commission recognized, is a monopoly service, and the POLR responsibility cannot be left unregulated, as it must be available if the market option fails.[40] The EDU is the only entity that is required to fill the POLR obligation. The EDU is the entity that operates the distribution wires and these wires must remain charged for connected customers to receive service; the EDU must have capacity available ancillary to the provision of the distribution service.[41]

As a monopoly provided service, POLR must be priced according to traditional cost of service principles, as contained in chapters 4905 and 4909, Revised Code. Indeed the Commission has recognized this and in First Energy's initial ESP filing, found that standby charges for generation (the equivalent of POLR) should be based on actual, prudently incurred costs to the electric utility of hedging against the risk of customers returning to the SSO.[42] There the Commission accepted the proposed rate subject to review and reconciliation on a quarterly basis to insure that it reflected the EDU's actual prudently-incurred costs. As OCC Witness Duann testified, the PUCO should, consistent

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[40] *In re AEP Ohio's IGCC Proposal*, Case No. 05-376-EL-UNC, Opinion and Order at 18 (April 10, 2006).

[41] Id.

[42] *In the Matter of the Application of Ohio Edison Company, The Cleveland Electric Illuminating Company, and the Toledo Edison Company for Authority to Establish a Standard Service Offer Pursuant to R.C. 4928.143 in the Form of an Electric Security Plan*, Case No. 08-935-EL-SSO, Opinion and Order at 28-29 (December 19, 2008).

with the approach taken in the FirstEnergy case, establish POLR based on actual, prudently incurred costs.[43]

Moreover, apart from this POLR precedent, precedent has been established for the pricing of energy and capacity based on actual out of pocket costs.[44] Such pricing is understandable, verifiable, auditable, and reconcilable. And in Ohio, it has been calculated this way for years.[45]

One of the most dangerous aspects of accepting the Companies' proposed value based pricing of POLR is that it permits AEP Ohio to extract from customers all the economic value to the customers for having the option to shop for electricity. As OCC Witness Duann testified, allowing value based pricing for a monopoly service permits the monopoly provider to exercise its market power to set a price that will maximize its profit at the expense of its customers.[46] *And that is just what AEP Ohio has done, and the Commission has allowed to this point. AEP Ohio originally sought over $500 million in POLR charges; the Commission approved $456 million in POLR charges to be collected from customers over the three year ESP term.*

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[43] OCC Remand Ex. 2 at 21-22 (Duann).

[44] See for e.g. *In the Matter of the Regulation of the Electric Fuel Component Contained Within the Rate Schedules of Ohio Power Company and Related Matters*, Case No. 99-101-EL-EFC, Opinion and Order (May 30, 2000), citing to Ohio Rev. Code 4905.301, 4909.191 and Ohio Adm. Code 4901:1-11-11(B) (which were subsequently repealed effective 1/1/2001); *In the Matter of the Application of the East Ohio Gas Company to Modify and Further Accelerate its Pipeline Infrastructure Replacement Program and to Recover the Associated Costs*, Case No. 11-2401-GA-ALT, citing to Ohio Rev. Code 4905.302 and Ohio Admin. Code 4901:1-14.

[45] See footnote 44.

[46] OCC Remand Ex. 2 at 19.

Such value based pricing for a monopoly service is unreasonable and contrary to public interest. It conflicts with the state policy to provide consumers with reasonably priced retail electric service.[47] It is inconsistent with traditional cost of service ratemaking under Chapters 4905 and 4909 of the Ohio Revised Code. It is inconsistent with the cost based approach taken by the PUCO in the FirstEnergy case.[48] It represents a break in precedent established by the PUCO whereby energy and capacity charges are calculated based on actual verifiable costs. It should be rejected outright and instead the POLR charges should be based on actual out of pocket costs to the Companies to provide incremental energy and capacity for returning, not migrating, customers.

2. The Black Scholes model used by the Companies fails to calculate out of pocket costs of POLR, but instead purports to value the optionality of switching rights to customers as well as the cost to the utility associated with lost revenues.

Despite the admonition of the Ohio Supreme Court that value to customers and cost to AEP Ohio are not the same,[49] the Companies once again have come forward to price POLR based on the results of a mathematical formula created to price exchange-traded options.[50] The formula, called the Black Scholes model, is the only direct

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[47] See R.C. 4928.02(A).

[48] *In the Matter of the Application of Ohio Edison Company, The Cleveland Electric Illuminating Company, and the Toledo Edison Company for Authority to Establish a Standard Service Offer Pursuant to R.C. 4928.143 in the Form of an Electric Security Plan*, Case No. 08-935-EL-SSO, Opinion and Order at 28-29 (December 19, 2008).

[49] *In re Application of Columbus Southern Power Company, et al.*, 2011 Ohio 1788, ¶26.

[50] See OCC Ex. 11 at 10-11 (Medine).

evidence AEP Ohio presents to support its POLR charge.[51] Setting POLR based on the value to customers of the optionality to shop is a non-cost based approach that is not verifiable, is not auditable, and not subject to reconciliation with actual costs incurred. In that sense it works well for the Companies because it is a black box approach that assures that revenues collected will not be scrutinized and AEP Ohio can simply pocket the revenues, no questions asked.

To pull off this approach, the Companies insist on characterizing POLR as a "financial risk" to them, despite the fact that the costs of energy and capacity to serve returning customers can be measured and despite the fact that the Commission has never approved pricing of energy and capacity as a financial risk. The financial risk allegedly calculated by the Companies is based on the value of the optionality provided to customers.[52] In other words, the Companies would charge customers for having the right *to switch and return*, with the value of POLR being set based on the value of the customers' switching rights. The Companies purport to measure the value of the customers' switching rights under the Black Scholes model, but as testified by OCC Witness Thompson and IEU Witness Lesser, the model fails to reflect the value.[53]

The Companies also allege that the Black Scholes model at the same time calculates the cost to the Companies of providing the switching opportunities to the

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[51] The Companies present evidence that purports to confirm the validity of the original Black Scholes results. Such evidence is in the form of a constrained Black Scholes model, as well as numerous studies presented by Witness LaCasse. Because the constrained Black Scholes model suffers from the same problems that the original Black Scholes model, the constrained model does little to advance the Companies' case. Additionally, the studies presented by Witness LaCasse are of little value as well since one cannot discern the discrete value of POLR under these studies. See Remand Tr. Vol. II at 168-178 (July 19, 2011).

[52] See OCC Remand Ex. 2 at 18-19.

[53] OCC Remand Ex. 1 at 22-24; IEU Remand Ex. 1 at 25-26.

customers.[54] The Companies define this cost as a "real and significant" cost to them, but one must closely examine what "real and significant" costs are being calculated. The costs purportedly calculated are the cost of "lost opportunities" for sales or revenues foregone by the Companies.[55]

Those lost opportunities are twofold. The Companies believe that when a customer shops the Companies suffer lost SSO revenues associated with that customer and believe they should be compensated for the lost SSO revenues.[56] Secondly, the Companies allege that when a customer returns, they also suffer lost revenues because they lose the opportunity to sell power in the market and must supply the customer at the SSO rate.[57] These claims for lost revenues, however must fail for the numerous reasons discussed below.

a. No guarantee of lost revenues exists under S.B. 221.

S.B. 221 does not guarantee that EDUs such as AEP Ohio will be made whole for sales of generation lost to CRES providers. Such a theory is antithetical to the underlying premise of SB 221—retail electric competition. There is no such provision in Chapter 4928 for this theory and the Companies have failed to show as much even though the burden of proof lies with them.[58]

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[54] Companies' Remand Ex. 4 at 10 (Thomas).

[55] Companies' Remand Ex. 5 at 5-7 (LaCasse).

[56] Remand Tr. II at 123-124.

[57] Id.; Companies' Remand Ex. 5 at 5-7 (LaCasse).

[58] See generally R.C. 4928.143(C)(1); *In re AEP Ohio's First Electric Security Plan Proposal,* Case Nos. 08-917-EL-SSO et al., Remand Entry at 2 (May 4, 2011) (finding that if AEP Ohio intends to seek a non-cost-based POLR charge or a POLR charge based upon costs, it should make the appropriate filing in these proceedings).

A review of the pertinent statutes reveals that lost generation sales opportunities associated with customers leaving AEP Ohio to take service from a CRES provider do not equal POLR. The statutes in fact refer to the POLR obligation arising from customers defaulting to the EDU's SSO (R.C. 4928.14(C)) or to the EDU providing "back up supply service" (R.C. 4928.01(A)).

Simply put, these statutes cannot be construed to cover migration costs—the costs of customers leaving-- in the form of lost revenues. Reading the words of the statutes in context and construing them according to technical or common usage, as required under Section 1.42, Ohio Revised Code, can lead to only one conclusion--providing default service or back up supply service means capacity and energy cost incurred when the customer must receive default or back up supply service. No more and no less.

Indeed where the General Assembly wanted to allow utilities to recoup lost sales opportunities or revenue foregone, it has expressly provided for such. For example, R.C. 4905.30 permits the Commission, with regard to economic development arrangements, the discretion to approve the collection of "revenues foregone." Additionally, under R.C. 4928.143(B)(2)(h), a utility's ESP may include "lost revenues" as part of the EDU's distribution infrastructure and modernization plans.

That the General Assembly provided limited conditions under which there may be costs collected from customers for lost or foregone revenues reflects the legislative intent to otherwise disallow costs to be collected under other conditions not specified. The legislative canon expressio unius exclusio alterius applies—the inclusion of one thing implies exclusion of the other.[59] The inclusion of authority to allow lost revenues for economic development and for distribution infrastructure and modernization plans, and not for POLR, was intended. The General Assembly, in its wisdom, enacted no provision for the collection of lost revenues through a POLR charge. The PUCO thus has no authority to allow EDUs to collect for lost revenues through the POLR charge.

Moreover, there are no provisions within R.C. 4928.143(B)(2) under which lost revenues fit, and thus the Commission may not authorize the collection of these lost revenues in the ESP.[60] Such a finding is in keeping with the Supreme Court's precedential ruling interpreting R.C. 4928.143(B)(2) to be an exclusive list that the ESP provisions must fall under to be authorized by the PUCO.

b. "Transition revenues" for AEP Ohio are not authorized by law any later than the end of the market development period, which for AEP Ohio ended December 31, 2005. Nor may the Commission authorize any "equivalent revenues" other than expressly permitted by R.C. 4928.31 to 4928.40. Lost sales from customer migration thus cannot be authorized as a POLR charge.

Under S.B. 3 the electric utilities were required to file plans to provide retail electric service in Ohio during the market development period.[61] Utilities were permitted to include a request for the opportunity to receive "transition revenues."[62] R.C. 4928.39 sets forth the criteria which transition costs (equating to transition revenues to the utility) must meet before being approved by the PUCO. Included in the transition cost criteria is

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[59] See *Crawford-Cole v. Lucas Co. Dept. of Jobs & Family Services,* 121 Ohio St.3d 560, 566, 2009-Ohio-1355, ¶42.

[60] See *In re Application of Columbus Southern Power Company, et al.*, 2011 Ohio 1788, 31-35.

[61] R.C. 4928.31(A).

[62] R.C. 4928.31(A)(5).

the notion that the costs must be unrecoverable in a competitive market, which is especially germane to the lost revenues being sought through POLR. The opportunity to recoup transition revenues ended when the maximum allowable period for transition charges expired on December 31, 2010.[63] Once that period was over, the Commission is precluded from authorizing the receipt of transition revenues or "any equivalent revenues" by an electric utility except as is expressly permitted under 4928.31 to 4928.40 of the Revised Code. Additionally, under R.C. 4928.40, the PUCO shall not increase the charge recovering revenue requirements associated with regulatory assets.

The Commission approved the Companies' transition plan filing in Case No. 99-1729-EL-ETP, et al.[64] In that proceeding, AEP Ohio agreed to forego $291.43 million in generation transition charges as part of a stipulation that settled the cases. These generation transition charges were associated with above-market, stranded generation costs and the value was based upon the difference between the generation components of historic rates and the Companies' projected market price of generation.[65] In other words, the generation transition charges were "lost revenue charges" that the Companies agreed not to impose on any switching customer.[66] Under the approved transition plan the market development period for AEP Ohio ended on December 31, 2005. Thus, by statute, the Commission is precluded from authorizing any additional receipt of transition

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[63] R.C. 4928.40(A).

[64] *In re AEP Ohio's Electric Transition Plan Proposal*, Case Nos. 99-1729-EL-ETP et al, Opinion and Order at 37 (September 28, 2000).

[65] Id.

[66] See *In re AEP Ohio's Electric Transition Plan Proposal*, Case Nos. 99-1729-EL-ETP, et al., Stipulation and Recommendation at 3 ("Neither Company will impose any lost revenue charges (generation transition charge (GTC)) on any switching customer.").

revenues or "any equivalent revenues" by an electric utility except as provided for in R.C. 4928.31 to 4928.40.

And yet the Companies' proposed POLR is just that—revenues that are the equivalent of transition revenues. By seeking to collect lost revenues for customers shopping and returning, the Companies are once again seeking to collect the difference between their generation rates (SSO) and the market price of generation. But such lost revenues, aimed at protecting the Companies from competitive risks, are not permissible under R.C. 4928.38 because the market development period has ended and the Companies have failed to show that the lost revenues are expressly permitted under R.C. 4928.31 to 4928.40. Hence, the Commission is without authority to approve POLR charges that represent lost revenues or any "equivalent revenues" beyond December 31, 2005.

c. The Commission Orders in the Companies' ESP Case and the CSP SEET case determined that profits from off-system sales were not relevant; thus it would be inconsistent with such orders to structure POLR to recoup off-system sales profits.

AEP Ohio seeks to capture, through its POLR charge, revenues for sales it loses to a CRES provider (at the SSO rate) as well as revenue foregone because instead of selling the power off-system at a higher market rate, it must sell the power back to the returning customer at the SSO rate. Essentially, AEP Ohio is seeking guaranteed profits from generation for every customer that shops and guaranteed profits for every customer that returns, as a result of its status as an EDU. Such a scheme was not intended in the original ESP Order of the PUCO, and should not be permitted through the remand.

In the original ESP Order the PUCO expressly ruled that profits from off-system sales could not be used to offset the revenue requirements associated with the ESP filing.[67] The PUCO ruled that the pertinent statutory provisions did not require that there be an offset.[68] Off-system sales should not be a component of the Companies' ESP or factored into its decision, the Commission determined. And similarly, in the PUCO's order in the Companies' significantly excessive earnings test ("SEET") case,[69] the PUCO ruled that profits from off-system sales should be excluded from the SEET calculation.[70] To now set the POLR charge to recoup any off-system sales opportunities (associated with customers switching and returning) would be inconsistent and contrary to these Commission decisions.

d. Allowing the companies to collect lost revenues associated with being non-competitive is unduly discriminatory and will impede the competitive market in Ohio.

As explained above, migration risks –or the risk of customers leaving --are not equal to POLR risks. The POLR risk defined by AEP Ohio would require customers to fund lost revenues associated with switching and returning customers. The collection of lost revenues, however, is not guaranteed by statute and has no inherent or identifiable link to POLR responsibilities of the Companies under the applicable statutes.

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[67] *In re AEP Ohio's First Electric Security Plan Proposal,* Case Nos. 08-917-EL-SSO et al., Opinion and Order at 17.

[68] Id.

[69] *In re AEP Ohio's Application Regarding the Significantly Excessive Earnings Test,* Case No. 10-1261-EL-UNC.

[70] Id., Opinion and Order at 30 (June 30, 2010).

The Commission should reject the notion that POLR amounts to lost revenue opportunities for the Companies. Doing so will advance the objectives of the legislation and will result in a just and reasonable result.[71] Providing a POLR to mitigate migration revenue loss will create an undue advantage for AEP Ohio vis-a-vis the CRES providers, protecting AEP Ohio from a business risk. Such an advantage is detrimental to establishing a competitive market for electric service, the main premise of S.B. 221. As such it would directly conflict with the policy objectives of R.C. 4928.02 and would undermine the cornerstone of S.B. 221—providing retail customers' choice of electric service supply. The PUCO should accordingly reject such an approach.

D. The Commission Should Reject the POLR Charges Based Upon AEP Ohio's Use of an Unconstrained Black Scholes Model.

The Black Scholes Model is once again back before the Commission, and AEP Ohio presents with it evidence that it believes confirm the appropriateness of the model. That evidence comes in the form of a new, constrained Black Scholes model, presented by AEP Ohio Witness Thomas, and several studies presented by Witness LaCasse.

Through rebuttal testimony, the Companies presented the results of Monte Carlo modeling to support the original results of the Black model. The Attorney Examiners permitted such testimony over the objections and motions of OCC and the other intervenors. This procedural ruling was erroneous for the reasons discussed below. Consequently, the Commission should overturn the Attorney Examiner's ruling and disregard the testimony as well as related testimony upon cross-examination on that subject.

[71] See, e.g., R.C. 1.47 which states that in enacting a statute a just and reasonable result is intended.

The OCC appropriately moved to strike the rebuttal testimony of AEP Ohio Witness LaCasse on the subject of her presentation of Monte Carlo modeling in connection with the POLR charge.[72] The basis of the OCC's motion to strike was the well established legal principle in Commission proceedings that proper rebuttal does not include material that could have been presented in the party's direct case.[73] The LaCasse "rebuttal" testimony should have been struck from page 7, line 9 through page 11, line 9.[74] The OCC's motion to strike was incorrectly denied,[75] and the Commission should correct this error.

As stated by the Commission concerning Ameritech's interconnection costs -- in the case cited in the OCC's oral motion to strike:[76]

> A review of the rebuttal testimony filed by the CLECs reveals that most of the witnesses have simply referred to a single passage of the cross-examination testimony of an Ameritech witness as a means of justifying the reiteration of prior testimony, or of presenting testimony that could, or should, have been presented as part of the CLECs' direct case.
>
> Although the CLECs have argued that Ameritech's motion is inconsistent with Ohio law regarding rebuttal testimony, the Commission has routinely limited rebuttal to testimony that a party could not have presented as part of their direct case.

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[72] Remand Tr. Vol. V at 637-641 (July 28, 2011). The OCC was joined in its Motion to Strike by other parties. Remand Tr. Vol. V at 641 (IEU), at 642 (OPAE), at 642 (Constellation) and at 643 (OHA).

[73] *In re Ameritech's Economic Cost for Interconnections*, Case No. 96-922-TP-UNC, Entry at 4, ¶(8) (January 29, 2001) ("evidence that could not have been presented as part of their direct cases").

[74] Remand Tr. Vol. V at 640-641 (July 28, 2011).

[75] Id. at 653.

[76] *In re Ameritech's Economic Cost for Interconnections*, Case No. 96-922-TP-UNC, Entry at 4-5, ¶(8) (January 29, 2001). The case appears in the oral argument in support of the OCC's Motion to Strike. Remand Tr. Vol. V at 637-638 (July 28, 2011).

AEP Ohio Witness LaCasse simply referred to the testimony of IEU Witness Lesser in an attempt to justify the presentation of testimony that could have been presented in the Companies' direct case.[77] As stated by the OCC's counsel at hearing: "Proper rebuttal [to Dr. Lesser's testimony] . . . would be presenting testimony on how the Black-Scholes models can be used to do so [i.e. value options under certain circumstances] and why Dr. Lesser is wrong. Instead, Dr. LaCasse backdoors in the [new] Monte Carlo analysis . . . ."[78]

The Companies stated in their filing on May 20, 2011 that they intended to support the reasonableness of their POLR charges based on additional modeling, supported by the work of Dr. LaCasse.[79] That filing contained an affidavit by Dr. LaCasse in which she stated that her organization, NERA, was working with AEP Ohio on modeling methods that could include a Monte Carlo study.[80] The late arrival of a study does not provide cause for its presentation in rebuttal testimony. Its late arrival and admission into the record was highly prejudicial.

The Attorney Examiner's ruling that denied the OCC's motion to strike the applicable portion of the LaCasse testimony should be reversed by the Commission. The testimony on pages 7-9 should be excluded from the record, consistent with Commission practice regarding the proper subject of rebuttal testimony.

Nonetheless, despite the newly proferred evidence of various studies that AEP Ohio's witness alleged "confirm" the results of the original Black Scholes model, the

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[77] Companies' Remand Ex. 5 at 7 (LaCasse).

[78] Remand Tr. Vol. V at 638 (July 28, 2011).

[79] AEP Ohio Initial Merit Filing on Remand at 27-28 (May 20, 2011).

[80] Id., Exhibit A at 5, ¶12 ("methods could include examining the costs that would be incurred to hedge these risks, using Monte Carlo modeling").

criticisms originally leveled at the model remain unanswered. OCC Witness Medine testified that Black Scholes is an untested and unproven tool to calculate a POLR charge.[81] Ms. Medine opined that the model's use was unprecedented in any regulatory proceedings where POLR revenues have been sought.[82] Instead, the model has been aptly described by the Ohio Supreme Court as a mathematical formula created to price exchange traded options.[83] Tellingly, AEP Ohio does not even use the model to value its own coal pricing options because it is not reliable.[84]

OCC and others previously criticized the model because it did not consider the actual costs of providing POLR.[85] The model is also unchanged in this respect as well. The model fails to calculate out-of-pocket costs associated with the POLR obligations.

For these reasons and those additional reasons set forth in the undersigned parties' briefs and the testimony of OCC Witness Medine, the Commission could simply reevaluate the evidence produced in the original record and reject the POLR charge. Nonetheless, if the Commission desires to wade into the POLR waters again, it will find additional reasons presented by OCC, IEU, and Constellation to reject the Companies' POLR charge, as discussed in detail below.

1. The Black Models used by the Companies incorrectly value POLR.

OCC Witness Thompson testified that the Companies' use of the Black model(s) to compute POLR is fatally flawed because of numerous programming, logic, and input

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[81] OCC Ex. 11 at 15-17 (Medine).

[82] OCC Ex. 11 at 17 (Medine).

[83] *In re Application of Columbus Southern Power Company, et al.*, 2011 Ohio 1788, ¶25.

[84] OCC Ex. 11 at 11 (Medine).

[85] OCC Ex. 11 at 12 (Medine).

errors.[86] IEU Witness Lesser also concluded that the Black model is inappropriate to estimate the switching optionality of customers because key assumptions that underlie that model's use do not apply.[87] The Commission should not accept AEP Ohio's results from the unconstrained Black model or its constrained option model to calculate POLR. OCC and OPAE offer the following observations on the Black models in order to assist the Commission in evaluating POLR claims made by the Companies.

a. The Black Scholes model used by AEP Ohio unreasonably assumes that customers' switching decisions are uniform and poised on a hair trigger, which overstates POLR.

Dr. LaCasse testified that when one uses an econometric model, one should attempt to make the assumptions in the model as close to reality as possible.[88] Dr. LaCasse further testified that when the Commission is deciding this case it should look at how closely the assumptions of the model reflect the realities that customers face.[89] And yet the Companies' unconstrained and constrained models make basic assumptions about customer behavior that are unfounded, unreasonable, and unrealistic.

According to OCC Witness Thompson, the unconstrained model assumes that a customer's decision to switch is solely based upon the relationship between the SSO price and the competitive retail market price.[90] Implicitly, the model assumes that all

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[86] OCC Remand Ex. 1 at 19.

[87] IEU Remand Ex. 1 at 4.

[88] Remand Tr. Vol. II at 278-280 (July 19, 2011) (LaCasse).

[89] Id.

[90] OCC Remand Ex. 1 at 20.

customers (100 percent) will switch for as little as a penny difference in generation price.[91]

As Witness Thompson testified, the decision to switch generation suppliers is much more complex. The model ignores numerous "non-price considerations"[92] such as customer loyalty to the Companies; the efforts of the Companies to communicate directly with customers who are considering switching, including proactive communications with customers; the fact that CRES suppliers may not be targeting certain customers; the degree to which the customer is aware of his choices; the degree to which the customer understands or is confused by his choice; the customer's perception of risk and his degree of risk tolerance; and the effort associated with researching prices and executing a transaction.[93] These are critical factors that influence the probability of a customer switching but they are completely unaccounted for in the model. Under the model, the more customers are assumed to shop, the greater the POLR cost to the Companies—hence the greater POLR charges imposed on the Companies' customers.

The Companies' own witness Dr. Makhija confirms that in addition to these specific non-price factors there are other factors that affect the customer's decision to switch. Dr. Makhija testified that customers may choose not to switch if there are issues related to price stability.[94] Additionally, both Drs. Makhija and LaCasse admit that there are transaction costs incurred by customers with switching that represent rational economic reasons that may prevent customers from switching, even when there is a

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[91] Id.

[92] Remand Tr. Vol. V at 859 (July 28, 2011) (Thomas) (model does not account for nonprice factors).

[93] OCC Remand Ex. 1 at 20.

[94] Remand Tr. Vol. I at 27-29 (July 15, 2011) (Makhija); Remand Tr. Vol. II at 167 (July 19, 2011).

differential between market and SSO price.[95] According to Dr. LaCasse, transaction costs exist and imply that at any given point in time when prices have fallen, some but not necessarily all, customers would switch.[96] And yet, the model fails to consider the impact of price stability and transaction costs on switching, choosing instead to assume 100% switching for as little as a 1 cent differential.

What this means is that the Companies' modeling of customer behavior under the Black model is flawed and does not comport with reality. This is because it assumes that 100% of customers switch at a penny differential. The model thus overstates the value of POLR, and the potential overstatement could be significant.

Witness Thomas downplays this flaw in the model, claiming that the Companies cannot know how customers make decisions to shop and thus cannot model the exact customer behavior.[97] Witness Thomas also purports to address the flaw by arguing that there are counterbalancing factors[98] that tend to negate any overstatement of POLR value.[99] Curiously, Witness Thomas can not say how much of the overstatement of POLR values is counterbalanced by these other factors because she has not quantified their impact.[100] This testimony only highlights why modeling of customer behavior is inappropriate to establish POLR costs. It is imprecise, does not comport with the complexities of customer behavior, and is skewed to establish a value for POLR that has

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[95] Remand Tr. Vol. I at 28 (Makhija); Tr. Vol. II at 167 (LaCasse).

[96] Remand Tr. Vol. II at 167 (July 19, 2011).

[97] See, e.g., Remand Tr. Vol. II at 252 (Thomas).

[98] Companies' Remand Ex. 8 at 4-7. These counterbalancing factors are community aggregation, switching just because customers can; and customers switching because they will receive other benefits or services beyond the price of generation from a CRES provider.

[99] See Companies' Remand Ex. 8 at 5.

[100] Remand Tr. Vol. V at 838.

no basis in reality. Such a modeling approach should be rejected in favor of calculating actual out-of-pocket POLR costs incurred by the Companies.

b. AEP Ohio committed serious errors in its application of the Black Scholes model.

OCC Witness Thompson testified that the Companies made significant errors in their volatility and date assumptions, which if corrected would reduce the Black derived estimate of POLR charges by at least 80 percent and possibly reduce it to zero.[101] These errors went uncorrected in the constrained Black model. And the constrained Black model was presented by the Companies as a check on the "reasonableness" of the original Black Scholes model.[102]

i. Price volatility assumptions were unreasonable.

The Companies calculated the volatility value they used in the Black model using the historic volatility of market quotes for forward energy prices.[103] The problem is that the Companies computed the volatility of only one of nine cost components that comprise the Companies' forecasted market price. This energy volatility component is then assumed to be a proxy for the volatility of the entire market price. Yet, the Companies provide no basis for assuming that the volatility of the energy prices is a reasonable estimate for the volatility of the other eight components which make up the total benchmark price. In fact it is not reasonable.

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[101] OCC Remand Ex. 1 at 28-36.

[102] OCC Remand Ex. 1 at 35-36.

[103] OCC Remand Ex. 1 at 28.

As testified by AEP Ohio Witness Baker, in the first phase of this proceeding, electricity is an extremely volatile commodity traded[104] and the option calculation of the Black Scholes model takes into account this extreme volatility when calculating the cost of the POLR obligation. The other components of the competitive benchmark price do not exhibit the same or even similar market volatility as energy. [105] For instance, OCC Witness Thompson testified that both the capacity and administrative cost component are fixed values which have little volatility.[106] The other components, though exhibiting some degree of market volatility, have not been shown by the Companies to exhibit the same volatility characteristics and have no ties to the volatility of energy prices.[107] OCC Witness Thompson concluded that this causes the volatility input to be overstated, and thus overstates the value of POLR derived under the model. Correcting for this error reduces the calculated POLR charge by approximately 73%.[108]

ii. The date assumptions did not fit the ESP framework.

OCC Witness Thompson testified that the Companies made two date errors: a term related date error and a purchase/expiration date error.[109] The term related date error pertains to the fact that the Companies ran a 41 month term, which is inconsistent with

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[104] Companies' Ex. 2A at 32 (Baker).

[105] OCC Remand Ex. 1 at 29.

[106] Id.

[107] Id.

[108] Id. at 30.

[109] Id.

the assumed[110] length of the ESP, 36 months. If the term related date error is corrected the calculated POLR costs are reduced by approximately 16 percent.[111]

The purchase expiration date error relates to the fact that the Companies have been charging customers for the cost of a purported 36 month European option every month of the ESP period. But as Witness Thompson testified, such an approach does not make sense because a European option can only be exercised at the end of the option term.[112] Thus, the Companies are asking customers to pay for the right to return to the SSO which right, in the Companies' model, cannot be exercised during the term of the ESP.

The exercise dates paid for by customers then fall outside the ESP period, and this presents a significant flaw in the modeling. This is problematic because the exercise date assumes the Companies have committed to a strike price beyond the end of the ESP term and have estimated market prices beyond the ESP term—neither of which they have done, or are willing to do. If this error is corrected by calculating an American option, which can be exercised at any time during the ESP period, with the cost spread over 36 months, the POLR charge would be significantly reduced.

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[110] Although AEP will argue the term of the ESP began January 1, 2009 and runs through December 31, 2011, the Ohio Supreme Court's decision on the retroactive rate issue makes it clear that the term of the ESP began April 1, 2009, subsequent to the Commission's modification and approval of the ESP.

[111] See OCC Remand Ex. 1 at Attachment MAT-8.

[112] OCC Remand Ex. 1 at 31.

2. The Black Scholes model fails to calculate the true cost of POLR, the value of the POLR to customers, or the Companies' alleged costs related to shopping risk.

a. The true cost of POLR

OCC Witness Thompson testifies that the Companies' true cost of providing POLR is not calculated under the Black model. This is because the Black model is a financial tool that calculates the so called POLR risks, which the Companies define as lost revenues. The lost revenues are the "real" and "significant" costs that AEP Ohio witnesses allege is the cost of POLR. Dr. LaCasse aptly describes them in the following exchange with OCC counsel:

> Q. (Ms. Grady) You define shopping risk as two parts; is that correct?
>
> A. (Dr. LaCasse) Yes.
>
> Q. In the first part you speak of the market price falling and customers switching to a CRES as part of the shopping risk; do you not?
>
> A. That's one side of the shopping risk is if the market prices fall sufficiently so that the CRES provider can beat the SSO price and customers have an incentive to leave and that imposes a cost on the EDU.
>
> Q. And you state that in that situation, AEP-Ohio will find that a portion of its output that is expected to be used to serve the SSO customers would instead need to be sold at below expected prices leading to a loss in revenue; is that correct?
>
> A. That is correct.
>
> Q. The second part of the shopping risk that you define is when -- is a shopping risk associated with customers returning to the EDU and that you speak of on line 23, page 5, carrying over to page 6, lines 1 through 3. Do you see that reference?

A.. Yes.

Q. And then you state that if the market prices rise, customers that are taking service from the market may find it advantageous to go to the SSO. Is that correct?

A. Yes. That assumes that the prices have first fallen sufficiently that the SSO customer would take service from a CRES provider and then, subsequently, that prices rise sufficiently that customers find it advantageous to return to the SSO price.

Q. And in that instance the electric distribution utility would be required to divert a portion of its output of its own generation or purchase from the market to meet its SSO obligation at the higher cost; is that correct?

A. That's correct.

Q. And these situations you describe are what you define as the cost of POLR, correct?

A. Yes. The cost of POLR is comparing a situation where customers would not shop and, therefore, the EDU would sell at the SSO price to all of its customers, compared to a situation where customers can shop, the market price can vary and, therefore, the EDU is facing those two risks and the costs associated with these risks.

Q. And these are risk costs, are they not, in your opinion?

A. These are? Excuse me, I didn't hear that.

Q. You described these as risk costs; is that correct?

A. As costly risks, yes. (Remand Tr. II at 142-143).

As discussed earlier the true cost of POLR does not include the migration risk – the risk of customers leaving. The true cost of POLR is the cost to provide incremental capacity and energy to the returning customer over and above the costs already being collected in SSO rates.[113] In order to make such a quantification the Black model would need to explicitly account for the manner in which capacity and energy charges are collected from customers in SSO rates, including the impact of the fuel adjustment clause rider.[114] But the Black model ignores these issues and instead relies on retail price inputs to determine lost revenues or lost opportunity sales for the Companies. These lost opportunities are not POLR costs.

b. The value of POLR to customers

The Companies allege that the Black model which calculates the Companies' lost opportunities also reflect the value of the POLR option to customers.[115] OCC Witness Thompson however testifies that the Black model does not accurately reflect the value of the POLR option to customers.

For POLR to have the option value implied by the Black model, customers must be able to return at a fixed price as assumed by the model.[116] This of course is not the reality due to the variable nature of a major component of the SSO price, the fuel adjustment clause. Other riders as well impact the total SSO price making a customer unable to return at the fixed price as assumed by the model.

Additionally, OCC Witness Thompson testified that the model returns a nonsensical result with respect to the value to the customer.[117] From the customer viewpoint the value of returning to the SSO lessens as the SSO price the customer returns

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[113] OCC Remand Ex. 1 at 22.

[114] Id.

[115] Companies' Remand Ex. 1 at 4 (Makhija).

[116] OCC Remand Ex. 1 at 22.

[117] OCC Remand Ex. 1 at 22-23.

to increases. That is the more the customer has to pay upon his return to SSO, the less valuable the ability to return will be to the customer. But under the Black Model if the SSO price increases, and all other inputs are held constant, the model indicates that the POLR charge should increase. Thus, the Black Scholes model suggests that the value of the option to switch increases as the SSO price increases, when the inverse of this is actually true.

c. The Companies' alleged costs related to shopping risks

As explained earlier, the migration risk, or the risk of customers leaving, is not a POLR risk. Rather it is a competitive business risk that is unrelated to the POLR obligation.[118] Thus, defining "shopping risk" to include the risk of customers leaving and returning as POLR is not appropriate.

Even if one were to overlook this definitional problem, OCC Witness Thompson concludes that the Black model does not accurately estimate the return risk imposed by the Companies' POLR responsibilities.[119] Dr. LaCasse argues that the POLR responsibilities born by the Companies cause the Companies to be unable to optimally manage their generation output by hedging their financial exposure to the spot market through forward sales.[120] In other words Dr. LaCasse claims that if the Companies had no POLR obligations, they could optimize their generation output by locking in long term non-jurisdictional sales and avoid losing revenue if market prices drop. This reasoning assumes that the Companies could in actuality lock in better deals absent POLR.

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[118] OCC Remand Ex. 1 at 25.

[119] Id.

[120] OCC Remand Ex. 1 at 25.

But the Black model does not perform an analysis that looks at a comparison between revenues actually derived from SSO retail sales versus revenues that could potentially be derived from an off-system sales alternative. Instead the model assumes the Companies are entitled to be without risk—being compensated at the SSO rate for every MWH of capacity and energy associated with customer leaving and compensated at the market rate for every MWH of energy and capacity associated with customers returning. This model assumption does not comport with reality because it does not factor into the equation the actual limitations placed on the Companies with respect to both the sale of energy and capacity. Hence the model overstates the lost opportunity revenues.

The Companies are limited in their ability to sell capacity due to the FRR capacity obligations as defined in the PJM reliability assurance agreement ("RAA").[121] These FRR rules require designated capacity to be made available to serve load in the zone; thus the ability to lock in a long term capacity sale for all capacity freed up from switching is not possible. In turn, while the model assumes compensation at an optimal level (SSO price or market price), revenues derived from off system sales, if allowed under the RAA, would likely yield revenues far below those recovered at the SSO rate and market rate modeled in the Black Scholes scenario.[122]

The Companies are also limited in their ability to sell energy off system at prices superior to revenues embedded in their SSO rates due to the AEP pool agreement.[123] Yet the model again assumes optimal sales of energy, ignoring the reality of these limitations.

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[121] Id. at 26.

[122] Id. at Attachment MAT-6.

[123] OCC Remand Ex. 1 at 27.

Thus, the Black model does not accurately calculate the lost revenue opportunities that the Companies claim are part of the shopping costs associated with the POLR obligation. This is another reason for the Commission to reject it.

E. The Commission Should not Impose POLR Charges Since AEP Ohio's POLR Risk is Already Covered by Means of the SSO Rate and the FAC.

If one accepts POLR costs as the costs of returning customers (without the cost of migration), then the Companies will be fully compensated for their POLR costs under their SSO rates for incremental capacity and energy costs, even without the POLR rider.[124] First, the Companies' SSO rates fully compensate the Companies for their cost of capacity to serve a customer.[125] This is because capacity resources required during the ESP period were known at the time of the ESP filing[126] and it is assumed that the Companies were well positioned to estimate their cost of capacity and incorporate that cost into their SSO rate.[127] If it happens that there are unanticipated capacity costs associated with a returning customer, those costs would be automatically collected via the fuel adjustment clause ("FAC").[128] There is no need for a separate POLR rider to compensate the Companies for the capacity costs of a returning customer.

Second, although potential incremental energy costs could also arise due to increases in cost of fuel and purchased power for costs assumed in the SSO rate, such

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[124] OCC Remand Ex. 1 at 12.

[125] OCC Remand Ex. 1 at 14.

[126] Under the PJM Fixed Resource Requirement capacity obligations the installed capacity that will be used to supply customer load must be identified three years in advance. OCC Remand Ex. 1 at 13, footnote 17, relying on the reliability assurance agreement.

[127] Id at 13.

[128] Id.

increases in cost of fuel or purchased power would be collected as well through the FAC rider.[129] Since fuel and purchased power costs incurred by the Companies are fully collected through the cost based FAC rider, the energy costs associated with a returning customer are fully collected. There is no need for a separate POLR rider to compensate for the energy costs of a returning customer.

F. The Commission Should not Require Customers to Pay Carrying Charges on Environmental Investment that was Made from 2001 Through 2008 Because S.B. 221 does not Permit the Companies to Recover These Costs.

1. Customer rates were excessive because they included payments for carrying charges on environmental investment made from 2001 though 2008.

AEP Ohio's residential customers were assigned approximately $330 million in carrying charges on the Companies' environmental investments made from 2001 through 2008, according to the PUCO's Order.[130] The PUCO allowed these collections from customers, in contravention of the provisions in R.C. 4928.143(B)(2).

The PUCO stated that it allowed these collections from customers "pursuant to the broad language of Section 4928.143(B)(2), Revised Code, permitting recovery for *unenumerated expenses*."[131] The Supreme Court of Ohio disagreed with the Commission's statutory interpretation. The Court stated:[132]

> The commission believes that the phrase "without limitation" [in R.C. 4928.143(B)(2)] allows unlisted items, asserting that the nine categories are "illustrative, * * * not exhaustive." But this phrase

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[129] OCC Remand Ex. 1 at 14.

[130] The Companies identified $110 million -- $26 million per year from CSP customers and $84 million per year from OP customers -- in environmental-related carrying charges each year of the three-year ESP. ESP Order at 24.

[131] Entry on Rehearing at 12, ¶(38) (July 23, 2009) (emphasis added).

[132] *In re Application of Columbus Southern Power Company, et al.*, 2011 Ohio 1788, ¶33.

> does not allow unlisted items. Rather, it allows unlimited inclusion of listed items.

The underpinning to the Commission's order regarding carrying charges on environmental investment -- that an expense that is not named in R.C. 4928.143(B)(2) can be the basis for rate-setting -- was determined to be an incorrect interpretation of Ohio law.

2. The investments during 2001 through 2008 are too early for recovery of carrying charges under Ohio law.

In the original case before remand, the Companies attempted to evade the clear provision in R.C. 4928.143(B)(2) that might apply to their proposed carrying charges on environmental investment because that provision contains an important restriction. But R.C. 4928.143(B)(2)(b) -- one of the "nine categories" addressed by the Court[133] -- permits an ESP to include "a reasonable allowance . . . for an electric generating facility of the electric distribution utility, provided the cost is incurred or the expenditure occurs on or after January 1, 2009." The environmental investments that underlie the carrying charges that are at issue on remand took place between 2001 and 2008. The Companies thus did not make these expenditures after January 1, 2009, as R.C. 4928.143(B)(2)(b) requires.

The carrying charges themselves do not represent expenditures that the Companies made after January 1, 2009 on environmental investments. Instead, the carrying charges result from the continued use of the capital expenditures made prior to January 1, 2009. As the Companies' witness Nelson stated:

> The capital carrying cost is determined by applying an annual carrying cost rate, expressed as a percent of the capital

[133] Id.

expenditure, to the total amount spent on a capital project or projects. The carrying cost rate includes the cost of money (weighted average cost of capital), a depreciation component, an income tax component, property and other taxes component and an administrative and general component. It does not include direct O&M expenses."[134]

The carrying charges are thus nothing more than bookkeeping entries during the period that began on January 1, 2009. They neither were incurred nor occurred after January 1, 2009, and as such are not collectable expenditures under R.C. 4928.143(B)(2)(b).

3. The carrying charges do not fall within the remaining categories of permissible costs under the Supreme Court of Ohio's decision.

As stated above, the Companies and the Commission viewed rate-setting based upon carrying charges on 2001-2008 vintage environmental investments to require that R.C. 4928.143(B)(2) permit "unenumerated expenses."[135] That interpretation of the Ohio statute having been rejected by the Supreme Court of Ohio, the Companies propose that the enumerated items stated in R.C. 4928.143(B)(2) permit the charges they seek.[136] This late-found argument should be rejected.

In R.C. 4928.143(B)(2), the General Assembly outlined the elements of electric security plans, and specified nine components that may be included in electric security plans. The listed components evince the intent to provide parameters that limit the type of expenses permitted. R.C. 4928.143(B)(2) specifically mentions only two categories of

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[134] Companies' Ex. 7 at 16 (Nelson). The Companies calculated a carrying cost rate of 5.8 percent for CSP and 16.38 percent for OP. See Companies' Ex. 1, Exhibit DMR-2 at 8 (Roush).

[135] Entry on Rehearing at 12, ¶(38) (July 23, 2009).

[136] Companies' Remand Ex. 2 at 4 (Nelson). The OCC appropriately moved to strike the testimony of AEP Ohio Witness Nelson on the subject of the interpretation of R.C 4928.143(B)(2). Remand Tr. Vol. I at 69-70 (July 15, 2011). Mr. Nelson opined that the statute provides "as least three bases . . . to support recovery of incremental environmental investment." Companies Remand Ex. 2 at 4. The witness is entirely unqualified to state this legal opinion. Evid. R. 702 (Ohio). The Attorney Examiner's determination not to strike the applicable portion of the testimony should be reversed by the Commission.

environmentally related costs that are collectable in an electric security plan. R.C. 4928.143(B)(2)(a) allows:[137]

> Automatic recovery of any of the following costs of the electric distribution utility, provided the cost is prudently incurred: the cost of fuel used to generate the electricity supplied under the offer; the cost of purchased power supplied under the offer, including the cost of energy and capacity, and including purchased power acquired from an affiliate; the cost of *emission allowances*; and the cost of federally mandated *carbon or energy taxes*.

Only the latter two costs -- emission allowances and federally mandated carbon or energy taxes -- are environmentally related. Neither is relevant to the carrying charges for environmental investment from 2001 through 2008.

The other environmentally related provision is R.C. 4928.143(B)(2)(b), quoted previously, which allows electric distribution utilities to recover:

> A reasonable allowance for construction work in progress for any of the electric distribution utility's cost of constructing an electric generating facility or for an environmental expenditure for any electric generating facility of the electric distribution utility, provided the cost is incurred or the expenditure occurs on or after January 1, 2009.

In order to be collectable under R.C. 4928.143(B)(2)(b), environmental costs must be incurred on or after January 1, 2009, and environmental expenditures must occur on or after January 1, 2009. The carrying charges for environmental investments made from 2001 through 2009, authorized by the PUCO in the ESP Order, do not meet either of these statutory criteria.

The Companies' new position, as revealed in AEP Ohio Witness Nelson's testimony,[138] is that Divisions (B)(2)(d) and (B)(2)(e) of R.C. 4928.143 support charging

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[137] Emphasis added.

[138] Companies' Remand Ex. 2 at 4 (Nelson).

carrying charges on 2001-2008 vintage environmental investments in addition to R.C. 4928.143(B)(2)(b) (the latter discussed above). R.C. 4928.143(B)(2)(d) mentions "carrying charges" in the context of ESP components that "have the effect of stabilizing or providing certainty regarding retail electric service." The perspective of the statute is a benefit to the Companies' customers, not to the Companies.[139] There is no evidence on the record that charging carrying charges on older environmental investments provides a benefit in terms of the stability and certainty regarding the service provided to customers.

R.C. 4928.143(B)(2)(e), also mentioned by AEP Ohio Witness Nelson, permits "[a]utomatic increases or decreases in any component of the standard service offer price." The carrying charges constitute a component of their own to the standard service offer, and not an adjustment mechanism to some other component. Division (B)(2)(e) of R.C. 4928.143 is totally inapplicable to the carrying charges proposed by the Companies.

Rate-setting based upon carrying charges on 2001-2008 vintage environmental investments are not, according to the Supreme Court of Ohio, permitted by reference to "unenumerated expenses"[140] in R.C. 4928.143(B)(2). The Companies' late-found proposal that the enumerated items stated in R.C. 4928.143(B)(2) permit the charges they seek is unsupported in the record, and should be rejected.

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[139] The statute, enacted in 2008, followed from the Commission's earlier support for rate stabilization plans that were evaluated on the basis of "rate certainty, financial stability for the electric distribution utilities and further competitive market development." *In re FirstEnergy RSP Application*, Case No. 03-1461-EL-UNC, Entry at 4-5, ¶(9) September 23, 2003). The "rate certainty" objective was from the customers' perspective.

[140] Entry on Rehearing at 12, ¶(38) (July 23, 2009).

G. The Commission Should Remedy the Unlawful Collection of POLR and Environmental Investment Carrying Charges.

1. Rates being collected subject to refund should be returned to customers.

Since June 2011, the POLR rider and the carrying charges on environmental investment have been collected subject to refund, as ordered by the PUCO.[141] As explained here and in the testimony of OCC Witnesses Duann and Thompson, AEP Ohio failed to present any additional credible evidence regarding the actual costs of providing POLR. On this basis the Commission should find that the POLR charge being collected subject to refund is not justified and should be discontinued. The PUCO should order the POLR rates being collected subject to refund (approximately $88 million for AEP Ohio[142]) since June 2011 be returned to customers with interest.[143] Additionally, because the carrying charges on pre-SSO environmental investment have no basis in law, approximately $64 million in AEP Ohio carrying charges[144] that are expected to be collected from June 2011 to December 2011 should be refunded in their entirety to customers.[145]

2. The interest on AEP Ohio's over-collections should be reasonable.

The Commission's Entry dated May 25, 2011 ordered that charges at issue in this case on remand would be subject to refund, and stated that in the event of refunds,

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[141] *In re AEP Ohio's First Electric Security Plan Proposal,* Case Nos. 08-917-EL-SSO et al., Entry (May 25, 2011).

[142] OCC Remand Ex. 2 at DJD-D, 1 of 1.

[143] OCC Remand Ex. 2 at 13.

[144] OCC Remand Ex. 2 at DJD-C, 1 of 1.

[145] OCC Remand Ex. 2 at 10.

"interest may be imposed on the amounts collected."[146] Such an interest rate should be reasonable,[147] and should be applied to the AEP Ohio's over-collections during the remand phase of this proceeding at the level recommended by OCC Witness Duann. OCC Witness Duann recommended "an interest rate of 10.93% . . . as the appropriate interest rate to be applied to the refunds."[148] That interest rate was developed during the initial phase of the case "for calculating the carrying cost on phase-in FAC deferral balance."[149] This interest rate is also consistent with the approach taken in earlier PUCO cases, and contrasts with the miserly interest rate proposed by AEP Ohio Witness Nelson (i.e. 3 percent).[150] Mr. Nelson's proposal should be rejected.

AEP Ohio Witness Nelson stated on cross-examination that he chose his 3 percent recommendation because it is "supported by public information."[151] The source cited by Mr. Nelson was Ohio Adm. Code 4901:1-17-05 regarding interest on customer deposits, a source Mr. Nelson admitted was inapplicable to the circumstances of these cases where the refund would stem from over-collections from customers resulting from inappropriately increased rates.[152]

Ohio Adm. Code 4901:1-17-05, cited in Mr. Nelson's prefiled testimony, does *not* specify the 3 percent interest rate selected by AEP Ohio Witness Nelson: it states that the

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[146] Entry at 4, ¶(9) (May 25, 2011).

[147] *In re Complaint of 15515 Van Aken Boulevard Corp.*, Case No. 85-1023-GA-CSS, Order at 47 (February 17, 1987).

[148] OCC Remand Ex. 2 at 29 (citing Attachment DJD-F).

[149] Id.

[150] Companies' Remand Ex. 2 at 5 (Nelson).

[151] Remand Tr. Vol. I at 92 (Nelson) (July 15, 2011).

[152] Id. at 79 (Nelson) (July 15, 2011). OCC Witness Duann agreed that Ohio Adm. Code 4901:1-17-05 is inapplicable to the circumstances of these cases. Remand Tr. Vol. IV at 547 (Duann) (July 21, 2011).

interest rate "will *not be less than* three per cent per annum. . . ."[153] Mr. Nelson prepared his miserly recommendation even though he knew that the comparable interest rate on customer deposits stated in the tariffs of Columbus Southern Power and Ohio Power Company has been 5 percent or more.[154] A more comparable circumstance to the issue at hand was the PUCO's use of the same 10 percent interest rate, plus or minus in favor of either the utility or customers, for adjustments to a utility's gas cost recovery rate following adjustments that resulted from an audit and a hearing.[155] While that PUCO rule applies to certain natural gas cases, it addresses the Commission's approach to circumstances where under or over-collections are made as part of riders that are part of rates charged to large groups of customers.

The Commission should set a reasonable interest rate to compensate customers for AEP Ohio's over-collections. That interest rate should be the 10.93 percent, set by applying the same methodology ordered by the Commission in the initial phase of these ESP cases to set AEP Ohio's carrying charge rate for the FAC phase-in deferral balance.

3. The Commission should order the adjustment of the phase-in deferrals to prospectively address the unjustified POLR and environmental carrying charges collected since April 2009.

During the ESP period from April 2009 through May 2011, it is estimated that AEP Ohio has collected approximately $368 million in POLR charges.[156] With respect to carrying charges on environmental investment, from April 2009 through May 2011, it is

[153] Ohio Adm. Code 4901:1-17-05 (B)(4) (emphasis added).

[154] Remand Tr. Vol. I at 86-87 (Nelson) (July 15, 2011).

[155] Ohio Adm. Code 4901:1-14-05(A)(2)(a).

[156] OCC Remand Ex. 2 at 23 ($235.3 million for CSP; $132.4 million for OP).

estimated that AEP Ohio has collected approximately $265 million.[157] In total approximately $633 million in POLR and environmental investment carrying charges have been collected from April 2009 through May 2011. These are the charges that the Supreme Court of Ohio determined were not justified, due to the evidentiary record before the PUCO. And it is these expenses that remain unjustified despite AEP Ohio's full opportunity in the course of this remand proceeding to develop and present a case for collecting such charges.

The collection by AEP Ohio of these unjustified POLR and environmental carrying charge revenues had a direct impact upon other portions of the ESP rates that were established by the PUCO. The FAC rates collected from customers during the ESP term were limited to established caps on annual revenues for AEP Ohio.[158] The PUCO's ESP Order determined that if FAC expenses were incurred greater than the annual caps established, AEP Ohio was permitted to defer such expenses for future collection (2012-2018) with carrying costs. As witness Duann testified, under the FAC and rate caps, the FAC rates for the Companies were essentially "residual values" between the capped rates and the sum of all non-FAC rates.[159] If the sum of all justifiable non-FAC rates (which included base generation rate, the POLR charge, and other riders) was less than the level approved by the PUCO, the allowed FAC rates would increase. Increasing the FAC rates would decrease the fuel expenses being deferred as well as the carrying costs associated with the deferred fuel.[160] Thus, because the Companies were permitted to collect ESP

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[157] OCC Remand Ex. 2 at DJD-C, page 1 of 1 ($62 million for CSP: $203 million for OP).

[158] ESP Order at 22-23 (March 18, 2009).

[159] OCC Remand Ex. 2 at 25.

[160] See OCC Remand Ex. 2 at 25.

rates that included unjustified charges, the resulting deferrals that are yet be collected from customers have been overvalued on a dollar-by-dollar basis associated with $633 million in unjustified POLR and environmental expenses.

OCC Witness Duann recommended that the value of the phase-in FAC deferral balance be adjusted consistent with the results of the remand proceeding.[161] For instance if the PUCO determines that the POLR charges collected and the environmental carrying charges collected to date have not been adequately supported by the Companies, the PUCO should re-calculate the amount of fuel expenses deferred and to be collected from customers. Witness Duann testified to the mechanics of recalculating the fuel expense deferrals.[162] This would necessitate the Commission ordering that the carrying charges from environmental investment and POLR be removed from the ESP rates. The result is that the deferred balance of fuel expense would be reduced accordingly.

While the Companies are expected to argue that the $633 million in unjustified charges cannot be returned to customers due to the prohibition on retroactive ratemaking, such arguments reveal a misunderstanding of the ratemaking rule and Ohio Supreme Court precedent. Under general ratemaking practice in Ohio, when a utility's rates are reversed on appeal, the Commission then implements revised rates minus the unlawful elements. This provides some degree of relief for customers, on a prospective basis, because the remaining rates no longer contain the unlawful elements. Here, the PUCO should remove the unlawful elements from rates that will prospectively be charged to customers. The unlawful elements have been preserved in the rates through the phase in

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[161] OCC Remand Ex. 2 at 26.

[162] OCC Remand Ex. 2 at 23-28.

deferrals which are to be collected from customers from 2012 through 2018. This happened because the structure of the ESP rates specifically linked the rates charged in 2009-2011 to the phase in deferrals that are to be collected from 2012 through 2018. The phase-in deferral rates were created as a residual value, flowing from the ESP 2009-2011 rates. The phase-in deferrals are a mechanism that permits the PUCO to make the future rate adjustments.

The Ohio Supreme Court has recognized, when faced with retroactive ratemaking claims, that if there is a mechanism built into the rates that allow for prospective rate adjustments, retroactive ratemaking does not exist.[163] Applying that reasoning here leads to the conclusion that there is no retroactive ratemaking because of the structure of the ESP rates and their inherent linkage to the phase-in deferral rates.

IV. CONCLUSION

At issue here is more than a half a billion dollars of charges related to POLR and environmental carrying charges –charges the Ohio Supreme Court determined were not justified on the basis of the record before them. Unfortunately, since April 2009, the Companies' customers have been paying and continue to pay the unjustified charges.

The Companies have produced scant evidence to satisfy the Court's concerns. The Companies remain wedded to the Black Scholes methodology to calculate POLR, despite the notable flaws in the model and the fact that results of the model do not

[163] See for e.g. *Columbus Southern Power Co. v. Pub. Util. Comm*, 67 Ohio St.3d 535, 541-541 (finding that because there was an initial order authorizing deferred revenues, there was no retroactive ratemaking); *Lucas County Comm'rs. v. Public Util. Comm.* (1997), 80 Ohio St.3d 344, 348-349 (noting that there was no mechanism for rate adjustment and no revenue from which the challenged program against which the PUCO could balance alleged overpayments or against which it could order a credit and thus it was retroactive ratemaking).

calculate the true cost of POLR—the incremental energy and capacity costs associated with *returning* customers. Instead the model produces an estimate of lost revenues, which have no basis in fact or law to be collected from customers in a S.B. 221 environment. The Companies have also failed to bear the burden of proving that the environmental carrying charges are an item that may be specifically included by virtue of an enumerated listing in R.C. 4928.143(B)(2).

The PUCO should act now to protect customers from bearing any more of these unjustified charges. The Commission should return to customers the charges being collected subject to refund. The Commission should also adjust the phase-in deferrals that are to be collected from the Companies' customers, taking out the unlawful charges pertaining to April 2009-May 2011 collections. The Commission has the authority to do so, and should exercise that authority.

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CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing Post-Hearing Brief on Remand was served electronically to the persons listed below, on this 5th day of August 2011.

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