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BEFORE THE
PUBLIC UTILITIES COMMISSION OF OHIO

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In the Matter of the Application of Columbus Southern Power Company for Approval of an Electric Security Plan; an Amendment to its Corporate Separation Plan; and the Sale or Transfer of Certain Generating Assets.	)	**Case 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**

COLUMBUS SOUTHERN POWER COMPANY'S AND OHIO POWER COMPANY'S REPLY BRIEF ON REMAND

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INTRODUCTION

The Commission reached the right result in its March 18, 2009 Opinion and Order (the "ESP Order") with respect to both POLR charges and the 2001-2008 incremental environmental investment carrying costs. The Ohio Supreme Court did not remand this case because it disagreed with the ultimate result the Commission reached. The Court remanded this case for the sole purpose of having the Commission better explain the basis for the allowance of the existing POLR charges and identify a different statutory basis to support the inclusion of environmental investment carrying costs in the AEP Ohio ESP. Remand Decision at ¶ ¶30, 35. The record, as supplemented on remand, provides the necessary record basis to further support and explain the Commission's original decision regarding the POLR charges. In addition, the legal basis for allowing recovery of the environmental carrying costs has been demonstrated. These carrying costs are permissibly included in the ESP under Ohio Rev. Code § 4928.143(B)(2)(d), (e) or (b). Staff concurs that the carrying costs are authorized by division (B)(2)(d).

With respect to the POLR charges the Court also asked the Commission to respond to the Intervenors "contrary positions." Id. at ¶ 30. The record and briefing on remand provides the Commission with the additional analyses that will assist it to articulate more fully why it rejected the Intervenors' contrary positions in its prior ESP Order and Entry on Rehearing. The Intervenors, for the most part, have reargued positions that they argued unsuccessfully in the prior proceedings. This is particularly true with respect to their continued criticisms of the use of an options model to estimate the Companies' POLR costs on an ex ante basis. They continue to react as if modeling or estimating costs is an impermissible approach, even though the Commission traditionally uses such an approach in other rate contexts. There is nothing in the

ESP statute that limits the Commission to considering only out-of-pocket expenses in determining standard service offer ("SSO") rates. Perhaps the biggest and most consistent flaw in Intervenors' contrary positions is the fact that their positions ignore the significant changes S.B. 221 made in the regulatory landscape. The electric industry in Ohio did not move to the full market structure contemplated by S.B. 3. In an effort to protect customers, S.B. 221 left the EDUs with a significantly expanded POLR obligation from that which S.B. 3 envisioned would be in place at this time. And as a result, as the Commission wisely recognized in the ESP Order, the Companies' ESP must "be one that provides rate stability for the Companies, provides future revenue certainty for the Companies, and affords rate predictability for the customers." ESP Order at 72. The existing POLR charges are an important component of the AEP Ohio ESP from the standpoint of each of these objectives. The Commission should re-affirm the ultimate findings of its prior order approving these charges and use the remand evidence and recognition in the record of the ongoing use of models to determine costs for traditional rate cases to document for the Court its rationale and why the Intervenors' contrary positions were properly rejected by the Commission.

ARGUMENT

I. THE COMMISSION CORRECTLY CONCLUDED IN ITS ESP ORDER THAT THE POLR OBLIGATION GIVES RISE TO A MIGRATION RISK AND THAT CONCLUSION REMAINS THE CORRECT AND CONTROLLING CONCLUSION FOR PURPOSES OF THIS REMAND PROCEEDING.

In this remand proceeding Intervenors seek to have the Commission reverse its prior determination that "the Companies should be compensated for the cost of carrying the risk associated with being the POLR provider, including the risk of migration." ESP Entry on Rehearing at ¶ 76. Staff says it now "tends to agree" that the migration risk is a risk of competitive markets and not a risk of being the POLR. (Staff Br. at 5.) This is complete about-

face from the Commission's findings in its ESP Order, and from the Staff position in the prior phase of this proceeding where "Staff witness Cahaan concluded that, if the risk of returning is addressed, then the migration risk is the only risk that should be compensated through a POLR charge." [1] ESP Order at 39. The Commission got it right the first time and should not now reverse itself on this key issue.

A. The Ohio Supreme Court did not redefine the POLR obligation to exclude the migration risk.

Certain Intervenors take the position that the Ohio Supreme Court held in its Remand Decision that the POLR risk encompasses only the risk of customers returning to the SSO after having first switched. That is a clearly erroneous position. The issue of whether the POLR obligation gives rise to a migration risk was not before the Ohio Supreme Court in the appeal. Neither IEU nor OCC raised that issue in their respective applications for rehearing and, therefore, could not and did not assert that as error in the appeal. Thus, the Commission's prior determination of this issue remains the law of the case for purposes of this remand proceeding, and cannot be altered at this late stage. The law of the case doctrine "precludes a litigant for attempting to rely on arguments at a retrial which were fully pursued, or available to be pursued, in a first appeal." Hubbard ex rel Creed v. Sauline (1996), 74 Ohio St.3d 402, 404, 659 N.E.2d 781. The issue of whether the POLR obligation gives rise to a migration risk was definitively decided by the Commission in its ESP Order, and therefore was "available to be pursued" in the

[1] At the initial hearing, Staff witness Cahaan acknowledged the "migration risk" to which AEP Ohio is exposed as a result of the Companies' obligation to provide all customers a SSO at rates determined to be more favorable than the expected market rates. He did so in his direct testimony (Staff Ex. 10 at 6-7), and again on cross examination (Tr. v. XIII at 27-39). While Mr. Cahaan was unsure whether the migration risk was properly considered a POLR risk in the traditional sense, he was firm in the view that there is a separate risk of migration and that it is a risk arising from the EDU's unique status and the requirement that it offer a standard service offer to all customers as required now by Ohio Rev. Code § 4928.141.

appeal. The only reason it was not pursued was that the Intervenors elected not to challenge this issue on rehearing, a precondition for pursuing it on appeal.

Intervenors make much of the fact that the Court described the POLR obligation in the Remand Decision as an "obligation to stand ready to accept returning customers." Remand Decision at ¶ 23 (citing Constellation NewEnergy, Inc. v. Pub. Util. Comm., 104 Ohio St.3d 530, 2004-Ohio-6767, 820 N.E.2d 885, ¶ 39, fn. 5). But by no stretch of the imagination does the Court's repetition, in an introductory paragraph in its discussion of the Commission's POLR findings, a short-hand reference to the POLR obligation contained in a footnote in a 2008 decision constitute a holding of the Ohio Supreme Court that the Commission erred in its conclusion that the POLR obligation gives rise to a migration risk. This is especially true because the Court had no need in the 2008 Constellation opinion to precisely define the components of the POLR obligation and the 2008 Constellation decision was based on a record and Commission order that pre-dated S.B. 221.

Prior to S.B. 221 the POLR obligation was described sometimes by the Commission and the Court using the "shop and return" short-hand language. See, e.g., Companies Remand Ex. 4 at 11. This case, however, presented the Commission with the first opportunity to actually define the risks associated with the POLR obligation after the enactment of S.B. 221. The Commission took up this issue head-on, heard the Companies' explanation of the risks, listened to the Intervenors' arguments, considered the Staff's position and ruled in its ESP Order that the migration risk is a component, indeed the largest component, of the risk arising from the POLR obligation as restated in S.B. 221. The Commission as in the past initially referred to the short-hand "shop and return" definition of POLR, but then concluded very definitely and precisely that there are two component risks subsumed in that definition, one being the risk of migration:

> As the POLR, the Commission believes that the Companies do have some risks associated with customers switching to CRES providers and returning to the electric utility's SSO rate at the conclusion of CRES contracts or during times of rising price. . . . we do not agree that there is no risk or a very minimal risk as suggested by some. . . . [B]ased on the record before us, we conclude that the Companies' proposed ESP should be modified such that the POLR rider will be based on the cost to the Companies to be the POLR and carry the risks associated therewith, including the migration risk.

ESP Order at 40. The Intervenors did not challenge this conclusion on rehearing, and it was carried forward into the Entry on Rehearing at paragraph 76. It is the law of the case. Hubbard ex rel Creed v. Sauline. It is a precedent requiring respect in this remand proceeding. Cleveland Elec. Illum. v. P.U.C. (175), 42 Ohio St.2d 403, 431, 33 N.E. 2d 1 (admonishing the Commission to "respect its own precedents in its decisions to assure the predictability which is essential in all areas of the law").

B. S.B. 221 expanded the nature of the POLR obligation which unquestionably justifies the reasonableness of the POLR charge.

In its brief, OCC argues that allowing the Companies to collect the existing POLR charges "is antithetical to the underlying premise of S.B. 221 – retail electric competition," and gives the Companies "an undue advantage that thwarts the very purpose of S.B. 221." (OCC Brief at 15, 22.) IEU too predicates much of its position on the framework of full retail competition envisioned by S.B. 3. While the Intervenors give lip-service to S.B. 221, their arguments ignore the unavoidable fact that S.B. 221 was passed specifically to address their fears that going to full retail competition as intended by S.B. 3, would expose retail customers in Ohio to higher market prices, result in an unacceptable level of price volatility, and was no longer a desirable option from the standpoint of retail customers.

The underlying premise of S.B. 221was that retail electric competition would be too risky for the customers unless there was some stable price alternative. Thus, S.B. 221 no longer

allowed an EDU to become "fully on its own in the competitive market," Ohio Rev. Code § 4928.38, and IEU's reliance on that concept and statute is entirely misplaced. (IEU Brief at 22-23.) In passing S.B. 221, the Ohio legislature stepped back from the S.B. 3 state policy of having only market-based SSO rates going forward and required all EDUs to submit in their initial application under the revised law an "electric security plan" ("ESP") that would be tested by comparison to whether the ESP "is more favorable in the aggregate as compared to the expected results that would otherwise apply under section 4928.142 of the Revised Code," which allows an EDU to submit a market rate offer ("MRO") for satisfy its requirement to provide a standard service offer, as required Ohio Rev. Code § 4928.141. Ohio Rev. Code § 4928.143(C). In doing so, S.B. 221 significantly expanded the EDU's POLR obligation. Under S.B. 3 the EDU was permitted to meet its POLR obligations by providing consumers a "market based standard service offer" after the end of the initial five-year market development period. Ohio Rev. Code § 4928.14 (as in effect prior to S.B. 221). After S.B. 221, the EDU still retained the POLR obligation to "provide consumers, on a comparable and nondiscriminatory basis within its certified territory, a standard service offer of all competitive retail electric services necessary to maintain essential electric service to consumers, including a firm supply of electric generation service," Ohio Rev. Code § 4928.141, but after the enactment of S.B. 221the EDU no longer have the guarantee that its SSO will be "market-based" as previously guaranteed by Ohio Rev. Code § 4928.14(A) in S.B. 3. Rather, an EDU providing service through an ESP is required to offer service to all customers at rates determined at the outset of the ESP to be more favorable in the aggregate than the estimated market rates for the term of the ESP, and must continue to offer the SSO rates regardless of whether and by how much market rates fall or rise. This imposes on

the EDU a new, very real migration risk, as the Commission properly recognized in its EDU Order.

Intervenors' and Staff's disagreement with the Commission is untimely. Moreover, it is plainly wrong to suggest that the migration risk is merely a competitive risk shared by all providers in the market. It is a risk imposed on the Companies as a matter of law by S.B. 221. As effectively established through the cross-examination of the Intervenor witnesses, no other provider is required by law to offer a firm supply of power to all customers. No other provider is required by law to offer service at a price determined by the Commission in any respect, let alone at a price that is determined to be more favorable than prices under a market rate offer. No other provider is legally estopped from raising its retail price when market rates rise. See Companies Initial Post Hearing Brief on Remand at 34-35; (see also Tr. v. III at 427-429 (cross examination of Constellation witness Fein).) Intervenors' competitive risk argument, and Staff's abandonment of its own Commission's holding by its tentative agreement with that argument, also completely ignores the fact that the Commission has recognized that all EDUs have this risk and should be compensated for this risk. The Companies' existing POLR charges are well in line with the POLR charges the Commission has approved for the other Ohio EDUs. Companies' Initial Merit Filing on Remand, at 19-20. In the case of the First Energy operating companies there is no doubt that the risk being passed along to the SSO suppliers through the competitive bidding process, the cost of which is recouped in SSO rates, includes the risk of migration as well as the return risk. *Id.* at 20.

Compensating the Companies, and other EDUs in Ohio, for incurring both risks arising from their POLR obligation does not, as OCC argues, "thwart the very purpose of S.B. 221." Quite to the contrary, it is the changes to S.B. 3 made by S.B. 221 that created the need to

establish the POLR charges that the Commission authorized in this proceeding. Compensating the Companies for standing ready to offer all customers – those who have not switched to a competitive retail electric service provider ("CRES") but have a right to do so at any time, those who have switched and retain the right to return at any time, as well as those who do return – a firm supply of generation service at the stable SSO rates approved in accordance with R.C. 4928.143(C) as being more favorable than a market rate offer is the necessary corollary of the price stability desired by the consumer advocates, encouraged by the business community and embraced as the *raison d'être* for S.B. 221. The Commission clearly recognized that S.B. 221 supplemented the "full, unfettered retail competition" theme of S.B. 3 with a more measured "competition but with stability protection" when it approved the Companies' ESP. The Commission acknowledged its statutory directive to balance competition and stability as follows:

> The Commission believes that it is essential that the plan we approve be one that provides rate stability for the Companies, provides future revenue certainty for the Companies, and affords rate predictability for the customers. Upon consideration of the application in this case and the provisions of Section 4928.143(C)(1), Revised Code, the Commission finds that the ESP, including its pricing and all other terms and conditions, including deferrals and future recovery of deferrals, as modified by this order, is more favorable in the aggregate as compared to the expected results that would otherwise apply under Section 4928.142, Revised Code.

ESP Order at 72.

C. The POLR charge does not deprive customers of the economic value of shopping or insulate the Companies from competition.

The existing POLR charges do not, as OCC suggests at page 12 of its brief, "extract from customers all the economic value to the customers for having the option to shop for electricity." OCC can dare to make such argument only by ignoring the fact that SSO rates started out on the very first day of the ESP at below market rates, approved by the Commission in accordance with Ohio Rev. Code § 4928.143(C). Contrary to OCC's argument, the customer retains the full

economic value from shopping. When market rates fall below the SSO rates, the differential goes exclusively to the customer; no part of the differential inures to the Companies' benefit because the POLR charge is already included in the SSO rates. However, there is no market upside – no win – for the Companies; they lose customers and revenue when the market rates fall and they are precluded from charging anything other than the SSO rates when market rates rise. The Companies have been precluded from the potential rewards of market pricing in their assignments as providers of last resort under their ESP. Their obligation is to provide a stable standard service offer as a hedge for customers against the risks of fluctuating market prices. Inherent in that responsibility is the associated risk that the Companies face as the holder of that unique statutory responsibility. It is fair and reasonable, therefore, that the Companies receive compensation for the risk they are forced to assume by offering stable rates for the duration of the ESP period, set below the market. [2]

OCC's argument that the POLR charge is stealing the customers' economic value is tied to its equally flawed assumptions that the POLR charge allows the Companies to obtain "guaranteed profits" and that because of the POLR charge "AEP Ohio will be made whole for the sales of generation lost to CRES providers." (OCC Brief at 15 & 19.) OCC's arguments reflect a fundamental misunderstanding of what the Companies' POLR option model is actually calculating.

The POLR model used by the Companies does not compute "lost revenue" as asserted by the Intervenors. Instead, it computes the cost of managing the risk of revenue or earnings

[2] Moreover, if shopping customers believe that paying the POLR charge is "extract[ing] all the economic value" of their option to shop, they have the choice granted by the Commission to waive paying the POLR charge. As shown in the testimony of Company witness Thomas, 98% of shopping customers choose to continue to pay the POLR charge leading to the strong conclusion that customers value the ability to return to the Companies' stable SSO rates rather than being subjected to the unknown market prices in the future. (Cos. Remand Ex 4 at 7-8.)

erosion related to the POLR obligation incurred by the Companies. The POLR model results in a known cost of the option to be paid by the customer. The customer then has only up-side potential in terms of the total savings that can be achieved by staying on SSO rates when market rates are higher, switching to a CRES provider when market prices are less than the SSO rates and potentially returning to SSO rates when market prices rise again.

On the other hand, in exchange for recovery of the cost of managing the risk, the Companies take on the risk that, depending on what market prices develop, the Companies will lose 100% of its bypassable generation-related revenue if all customers shop, the Company will be no better off if no customers shop, or something in between. The Companies can do no better than its SSO rates. Clearly, in exchange for payment of the POLR charge, the customer has the upside potential while the Companies only have downside potential related to market price movements.

The fact that POLR model does not calculate either the total potential benefits to customers or the total potential losses to the Companies was directly addressed by Companies witness Baker in his direct testimony:

> The financial risk inherent in such arrangements is a result of the asymmetrical relationship that exists between the two parties – one party is holding the rights that will bring financial benefits to themselves and at the same time impose financial losses on the other party.

(Cos. Ex. 2A at 30.)

The Companies' POLR charges do not translate into the Companies recovering "lost revenues" from their customers as asserted by the Intervenors. It translates into the Companies being reasonably compensated for the migration risk to which it is exposed as a result of supporting the POLR obligation. As noted above the Commission Order understood this when it stated that "The Commission believes that it is essential that the plan we approve be one that

provides rate stability for the Companies, provides future revenue certainty for the Companies, and affords rate predictability for the customers." ESP Order at 72.

OCC and the other Intervenors seek to obtain the benefits of the POLR backstop provided by the Companies while depriving the Companies from recovering any of the costs of assuming the associated migration risk and providing the rate stability that the Commission believes is essential. While the expected cost of migration risk may on, an ex ante basis, be similar to the expected ex ante savings that customers could realize from shopping, the POLR charge does not provide compensation for actual "lost revenue". If in fact prices were to fall, the Companies' revenue erosion and the customers' total realized savings from shopping could far exceed the POLR charges collected. Additionally, one of the underlying assumptions of the Companies' option model is that the Companies will be able to secure alternate sales at the retail level if customers do in fact migrate. However, replacing all such sales at that level is extremely unlikely. The Companies also face financial risk from exposure to the spot market if they do not secure alternate sales, which is not quantified or taken into account in the calculation of the POLR charge. In addition, the Companies do not have the opportunity to offset any revenue erosion when market prices are high. Hence the approach taken by the Companies is a conservative measure of the cost of migration risk. (LaCasse Dep. at 53; Cos. Remand Ex. 3 at 18.)

The Intervenors' positions in this remand proceeding fail to take into account the very salient fact that the Commission found in this case that the estimated cost of the Companies' ESP, with the POLR charge included, was still more favorable to the customers than the estimated market rate option. ESP Order at 72.[3] That financial advantage of the Companies'

[3] The Commission calculated the cost of the Companies' modified and approved ESP to be $673 million for CSP and $747 million for OPCo, and the cost of the MRO to be $1.3 billion for CSP and $1.6 billion

ESP for customers, compared to what the MRO alternative was expected to cost them, was determined after taking into account the costs of the POLR charges and the 2001-2008 incremental environmental investment carrying costs that the Commission had included in the Companies' ESP.

Accordingly, the Companies' customers began the ESP already better off than under an MRO. But the advantages of the ESP did not stop there. Because S.B. 221 requires that an electric distribution utility (EDU) operating pursuant to an ESP commit to charging the ESP SSO generation prices for the term of the ESP, while allowing customers the option of switching to competitive generation suppliers if market prices decline below the ESP SSO prices, customers had, from the outset of the Companies' ESP, the additional "upside" opportunity of reaping the benefits from market prices in the event they declined below the ESP's SSO prices. In addition, customers were insulated, through their statutory entitlement to the ESP's SSO pricing for the entire term of the ESP, from any increases in market prices above the ESP pricing, either while they took service under the ESP (because they had the option to continue taking the SSO generation service at the below market ESP prices in that event) or after they had switched to a competitive supplier (because they had the option return to the ESP at its regulated SSO rates).

The POLR charges provide some compensation to the Companies for the cost of bearing: the additional downside risk that market prices might decline below their ESP SSO prices and that customers might then migrate to competitive generation suppliers, leaving the Companies to sell their generation supplies at the lower market prices; and the further risk that customers might subsequently return to the ESP SSO in the event that market prices increased back above the ESP

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for OPCo. Consequently, the cost benefit of the ESP for customers, based on those values, was, for CSP, $1.3 billion – $673 million = $627 million; and, for OPCo, $1.6 billion - $747 million = $853 million; or a total cost benefit to customers of $1.480 billion. Opinion and Order, at page 72. By its July 23, 2009 Entry on Rehearing the Commission noted that the additional "modifications made in [that] entry increase the value of the Companies' ESP.

prices, thus requiring the Companies to purchase generation supplies for those returning customers at the higher market prices while charging them the ESP SSO prices. In short, the POLR charges are not a "make whole" arrangement through which the Companies recover lost revenues that result from shopping customers or the increased costs of power supplies purchased to serve returning customers.[4] To the contrary, the charges are compensation for the risks to which the generation used to meet the POLR obligation is exposed and are necessary to provide the Companies the rate stability that the Commission has recognized is required.

Nor do POLR charges, contrary to other Intervenor arguments, take from customers the financial benefit they obtain in the event that they switch to a competitive generation supplier when market prices fall below the ESP pricing. First, as explained above, customers receive substantial financial benefits under the Companies' ESP, from the outset and for its entire term, because the cost to them of the ESP, including the POLR charges, is below the cost of the MRO alternative. Second, if market prices fall below ESP pricing and make competitive generation suppliers' offerings financially advantageous, customers can switch to the lower-priced competitive alternative, and in that event they keep the entire benefit of the lower-priced alternative.

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[4] OCC argues that because the POLR charge allows the Companies to obtain "guaranteed profits from the generation [for shopping customers], the charge "is inconsistent with the Commission's determination that profits from off-system sales ["OSS"] should not be considered in this ESP case. (OCC Brief at 19.) The argument merely recycles in a different context an argument OCC made on rehearing and the Commission rejected. See Entry on Rehearing at 3-4, ¶¶11-14 (July 23, 2009). OSS are non-jurisdictional revenues and are not properly included in any ESP proceeding. The financial risks and costs associated with discharging the POLR obligation, are properly considered in establishing the Companies' SSO rates, because they risks and costs relate directly to the legislative promise of rate stability for Ohio retail customers. OCC's theory is wrong and its predicate assumption – that POLR charges result in guaranteeing generation profits – is also wrong.

D. Intervenors' other mischaracterizations of the POLR obligation are not properly raised in this remand proceeding and have no merit.

In their post-hearing briefs, Intervenors raise several arguments based on mischaracterizations of the POLR obligation, POLR risks or POLR charges so as to suggest that the Commission is not authorized to approve any POLR charge in a proceeding commenced under Ohio Rev. Code § 4928.143. These arguments are not properly raised in this limited remand proceeding as they were either raised and rejected in the prior proceedings in this case or should have been raised in the prior proceedings. Moreover, the arguments have gained no merit due to the passage of time.

1. The POLR obligation is an obligation to provide generation service.

OCC argues that the Commission has no authority to approve the POLR charges in this proceeding because POLR is a monopoly distribution service that must be priced according to Ohio Rev. Code Cptrs. 4905 and 4909. (OCC Brief at 10.) POLR service clearly is not a distribution service. Rather, it is related to the generation function. The POLR obligation is a requirement to provide a firm supply of power as a component of the Companies' generation SSO. It is a mandatory component of the SSO generation service all EDUs are obligated by law to provide under Ohio Rev. Code § 4928.141. The Commission has consistently allowed for the recovery of the POLR charges in the EDUs' rate stabilization plans (RSPs) and through proceedings under Ohio Rev. Code § 4928.143, and the charges approved in such proceedings were not determined based on traditional rate base/rate of return analyses. See Case Nos. 08-1094-EL-SSO (Dayton Power & Light Co.); 08-920-EL-SSO (Duke Energy); 08-917-EL-SSO, *et seq.* (AEP Ohio); 05-246-EL-AIR (Dayton Power & Light Co.); 04-169-EL-UNC (AEP Ohio).

2. POLR charges are not transition charges.

Both OCC and IEU advance the argument that the Companies' existing POLR charges "are the equivalent of transition revenues," and, therefore, cannot be recovered because the authority to allow transition revenues to be recovered ended with the end of the Companies' market development period under Ohio Rev. Code § 4928.38. (OCC Brief at 17-19; IEU Brief at 22-24.) This is one of the several arguments in which Intervenors simply ignore how S.B. 221 changed the regulatory landscape. The POLR charge has nothing to do with a "transition" to full market competition, as envisioned by R.C. 4928.38. The POLR charge arises from the Companies' obligation under S.B. 221 to continue to offer a firm supply of power to all customers and to do so at stable SSO rates determined by the Commission to be better than the expected market rates for the term of the ESP. To the extent that the POLR charge is compensating the Companies for their cost of managing the risk, it is an exposure or risk that results from the expanded obligations imposed by S.B. 221 rather than from the unrealized expectation that the EDU would be "fully on its own in the competitive market," after the end of the market development period legislated in S.B. 3.

3. The Companies' participation in the PJM is irrelevant to the issue of whether the Companies' state law POLR obligation subjects them to financial risks.

IEU continues to argue that the Companies' obligation to provide an SSO, post-S.B. 221, creates "no risk regarding the physical provision of service because all generation requirements are governed by the operations of PJM Interconnection, Inc." (IEU Brief at 20.) IEU acknowledges, however, that the Companies' SSO obligation "might create financial risk for the EDU." (Id.) IEU must concede at least this point because IEU witness Murray agreed that AEP Ohio's obligations under the PJM tariff are distinct from the statutory SSO obligation under Ohio

law; that PJM membership does not require AEP Ohio to provide a firm supply of generation to retail customers, and that the PJM membership and the PJM tariff deal with wholesale matters exclusively. (Tr. v. IV at 574-578.)

It is not clear what point that IEU seeks to make based on distinctions between "physical" and "financial" POLR risks. The Companies have always contended that their position as EDUs that are obliged to provide SSO generation service pursuant to an ESP at regulated, stable prices while customers retain the options either to remain on the SSO at the ESP prices, to switch away from the SSO to obtain lower prices elsewhere, and also, subsequently, to return to the SSO at ESP prices when that is advantageous, creates significant and costly financial risks that merit compensation. PJM's responsibilities, and the Companies' participation in PJM as a load serving entity, do not mitigate in any way the financial risks, and costs, that the Companies bear as POLR entities operating pursuant to an ESP that guarantees all customers the option of stable SSO prices.

4. The current SSO rates do not cover any component of the cost associated with the shopping optionality.

OCC argues that the SSO rates and the fuel adjustment clause fully compensate the Companies for that component of the POLR charge that relates to the cost of customers returning to the SSO after shopping. (OCC Brief at 36.) IEU makes a similar argument. (IEU Brief at 24-25.) The argument is based on the assumption that the SSO rates fully compensate the Companies for their cost of capacity to serve the customers, including customers who shop and return, because the Companies accurately estimated their capacity cost at the time the SSO rates were established. (OCC Brief at 36.) The argument, of course, completely ignores the fact that the Commission has already determined that there is a migration risk and that the migration risk is the larger component of the POLR charge. And it ignores the key fact that the Companies do

not collect the SSO rates from customers once they exercise their right to shop. The argument further ignores the fact that, even making the erroneous assumption that the POLR obligations is limited to the returning load, that there is a substantial load from customers who have already shopped and could return at any time. The Company is unable to plan for any such return resulting in potential increased costs that will then either be borne by the Company or by all non-shopping customers.

In sum, in each of the arguments addressed in this section, Intervenors are wrongly misusing this remand proceeding to now attempt to argue that the POLR charge should be eliminated in toto, or reduced to only cover the risk of return, on grounds that were previously rejected by the Commission or grounds that could have been raised in the prior proceeding but were not. The Commission previously determined that the POLR charges were necessary to compensate the Companies for assuming the risks imposed upon on them as the POLR under the stability and predictability mandates imposed by S.B. 221. The only issue to be revisited in this proceeding is whether the amount of the charge is justified in the record either on a cost basis or on some other basis.

E. R.C. 4928.143(B)(2)(d) expressly allows for the recovery of POLR charges.

In addition to mischaracterizing the POLR charges and challenging the justification for the existing Commission-approved POLR charges, IEU now expands its argument to a full bore attack on the Commission's authority to recognize POLR charges, however characterized or justified, arguing that there is no legal basis for allowing any POLR charges. (IEU Brief at 3, 6 and 18.) That is simply untrue and such an argument, if accepted, would mean that the Commission acted *ultra vires* each of the multiple times it approved the recovery of POLR charges in the past. See, e.g., Case Nos. 08-1094-EL-SSO (Dayton Power & Light Co.); 08-920-

EL-SSO (Duke Energy); 08-917-EL-SSO, *et seq.* (AEP Ohio); 05-246-EL-AIR (Dayton Power & Light Co.); 04-169-EL-UNC (AEP Ohio).

The existing POLR charges are expressly authorized by statute. Ohio Rev. Code §§ 4928.141 and 4928.143, the current source of the POLR obligation, requires the Companies to have a firm supply of generation for all customers in its service territory during the ESP term. The guarantee of a firm supply of power extends to existing customers who do not switch, customers who switch and may someday return, and customers who have switched and subsequently return. Ohio Rev. Code § 4928.143(B)(1) provides that: "An electric security plan shall include provisions relating to the supply and pricing of electric generation service." This statute alone is sufficient authority for the Commission to recognize the POLR obligation and associated risks to the Companies, but the statute does not stand alone. Ohio Rev. Code § 4928.143(B)(2)(d) expressly provides that an ESP may include "terms, conditions and charges relating to . . . bypassability, standby service . . . default service, . . as would have the effect of stabilizing or providing certainty regarding retail electric services." The POLR charge falls squarely within this provision because under the S.B. 221, the Companies' POLR obligation to provide an SSO for all customers in their service territory and do so in the case of an ESP at rates determined to be more favorable than a market rate offer – and in the case of the Companies was determined to be $1.6 billion more favorable –exists primarily as the mechanism to assure stability and predictability in the pricing of retail electric service.

The Companies POLR charges are cost-based, as the record supplemented on remand demonstrates. Significantly, however, R.C. 4928.143(B)(2) does not actually require, as many other divisions in the statute do, that any charges included in the ESP effecting stability and certainty in retail electric service must be cost-based. Compare, § 4928.143(B)(2)(d) with §

4928.143(B)(2)(a) (providing for certain enumerated "costs" if prudently incurred), § 4928.143(B)(2)(b) (construction costs and environmental expenditures) and § 4928.143(B)(2)(h) (infrastructure modernization costs)[5]. Because neither R.C. 4928.143(B)(1) nor (B)(2)(d) requires provisions relating to the pricing of electric generation service, including standby and default service, to be cost-based, IEU's reliance on Ohio Consumers' Counsel v. Pub. Util. Comm., 114 Ohio St.3d 340, 2007-Ohio- 4276 is misplaced. The record and Commission order in that case predated S.B. 221 and the enactment of R.C. § 4928.143. Moreover, the Ohio Supreme Court expressly noted in its Remand Decision in this case that the Commission could consider "whether a non-cost-based POLR charge is reasonable and lawful." Remand Order at ¶ 30. R.C. 4928.143(B)(1) & (B)(2)(d) directly answer that question in the affirmative.

R.C. 4928.143(B)(2)(d), in particular, quite appropriately recognizes that when the Companies are required to provide a service to all customers in order to effect stability and predictability in the pricing of retail electric service, that service confers a benefit on all customers and it is appropriate for the ESP to include a charge for that service whether regardless of whether the EDU incurs a cost in the traditional "out-of-pocket expense" sense of the word. Here the benefit conferred upon the customer – upon all customers at the outset of the ESP period and continuing throughout the ESP period – is the option to shop when market rates fall

[5] OCC relies on this latter division to argue that R.C. 4928.143 cannot be read to permit the recovery of the existing POLR charges because the Companies' charges are akin to "lost revenues." (OCC Brief at 16.) While the option model uses the expected difference between the ESP price and market price, as well as other factors, in estimating the cost of the shopping optionality to the Companies and the value of the optionality to the customers, the POLR charge by no means allows the Company to recover its potential "lost revenues" due to shopping. The Companies are exposed to revenue erosion costs far in excess of the amount customers paid for the option. But, even if the charge is considered to akin to a charge for "lost revenue," it does not fall outside the scope of R.C. 4928.143(B)(2)(d) because that division of the statute does not qualify or limit the "terms, conditions or charges" allowed for standby or default service except to require that they have the effect of "stabilizing or providing certainty regarding retail electric services." The fact that division (B)(2)(h) permits "lost revenues" to be a recoverable "cost" for purpose of a infrastructure modernization plan does not mean that that "lost revenues" are excluded from the earlier division, which contains no cost-based limitation. Division (B)(2)(h), however, does clarify that "lost revenues" may be considered a type of "cost."

below the SSO rates. The option to shop takes on added value to the customer because the customer can now shop, if and when the customer chooses to do so, with the comfort of knowing that a firm supply of power at stable SSO rates will remain available to it. These options for the customer have a cost associated with them. The Companies are allowed to collect a charge for providing that added benefit, whether the charge is intended to recognize an out-of-pocket expense, another form of cost to the Company, or the need to provide some modicum of financial stability or risk-mitigation to the Companies. As the Commission correctly noted in the conclusion to its ESP Order, " it is essential that the [ESP] plan [it] approve[s] be one that provides rate stability for the Companies, provides future revenue certainty for the Companies, and affords rate predictability for the customers." ESP Order at 72. And as Companies witness Thomas noted in her rebuttal testimony, an after-the-fact determination of out-of-pocket expenses would not be a proper way to determine the cost of the Companies' POLR obligation because, among other reasons, it would diminish the safety net effect of the stabilized SSO rates because "customers would face the unknown risks and would not know until afterward whether any decision to shop, and possible waive the POLR charge, was going to provide a net benefit. (Cos. Remand Ex. 8 at 3.)

Companies witness Baker explained succinctly the nature of the POLR obligation, the risk that results from that obligation for an EDU that is committing to stable, regulated SSO pricing for the term of the ESP, and the need to recognize and compensate for that risk on an ex ante basis rather than retrospectively:

> Trying to recover the costs of the Companies' POLR obligation retrospectively would fail, because it ignores the very nature of the POLR obligation. The value of the customers' right to switch under S.B. 221 comes from the *option* customers are given to switch suppliers, while still having the safety net of the ESP rate to come back to, *if* electricity prices move in a way that makes

> switching back to the Companies an economically attractive choice or if their supplier defaults.
>
> The value of that option exists at the beginning of the ESP term, independent of the actual outcomes. The Companies are committing now, based on current circumstances and uncertainties, to provide an SSO price for the full three-year period of the ESP. The seller of that option, in this case the Companies not a third party supplier responding to an auction, assumes the *risk* of customer switching. The consequences leave the Companies exposed to costs far in excess of the amount customers paid for the option. The source of the value for customers, given to them through the right to switch providers, comes from the choice they have in the future to switch if it is to their benefit, and to return to the ESP price when that option is to their benefit. The cost of the POLR obligation for the Companies arises from the fact that the Companies must manage their portfolio recognizing the options given to customers – or face much higher costs when the option is exercised. Such a "heads I lose, tails I lose" proposition, which would result from not compensating the Companies for the risk, is fundamentally unfair.
>
> Finally, the assertion that it appears unlikely customers will exercise their right to switch, given existing market prices, and therefore that risk can be ignored, is very dangerous. One lesson that the current economic turmoil painfully demonstrates is that ignoring the risk of unlikely events can result in staggering losses if the unexpected occurs. SB221 reemphasizes Ohio's commitment to customer choice. The potential benefits of customer choice have corresponding risks that should be recognized and managed *before* they occur.

(Companies' Ex. 2E, pp. 14-15, emphasis in original).

F. The Black option model, as well as the Monte Carlo model, provide a reasonable basis for the existing POLR charges.

The Intervenors, in predictable fashion in light of their witnesses' testimony, criticize the Companies' reliance upon the refined and improved constrained Black option pricing model as well as the original unconstrained Black-Scholes option pricing model. Their primary criticism is that an option pricing model cannot be used for the purpose of estimating their costs of bearing the POLR risks and, thus, establishing their POLR charges. Their secondary criticism is that the

Companies' implementation of the option models it has sponsored is so flawed that the results are not a reliable basis for establishing POLR charges. OCC also contends that the Monte Carlo model's results should not be used to support the charges. (OCC Brief at 21.)

With regard to the Intervenors' primary argument that an option pricing model cannot be used to estimate the Companies' POLR costs and therefore their POLR charges, they are simply incorrect. The Commission already has determined in this case that the unconstrained Black-Scholes option model (and because it would provide an even stronger basis, the refined and improved constrained Black option model) can provide a reasonable basis for estimating the Companies' POLR costs and charges. At this point, in this case, the question is not whether the option pricing models are useful and reliable tools for quantifying the Companies POLR risks and establishing their POLR charges. The question is whether the record, as supplemented on remand, demonstrates that the option pricing model estimates the costs to the Companies of providing POLR service in the context of their ESP and does not simply provide an estimate of "what customers are willing to pay" for their POLR options.

The remand proceeding provides the Commission the opportunity to clarify and provide a more detailed explanation in the record for the industry, and if needed for the Supreme Court, for the conclusions previously reached and further supported in the remand record— advanced modeling is an appropriate manner to determine regulatory costs. Despite the Intervenors attacks and assertions that the Court somehow precluded all constructive actions by the Commission when remanding the case, the fact remains the Court provided the Commission a vehicle to support its earlier conclusion that the existing POLR charges are appropriate. The Commission need to look no further than the Intervenor testimony to support this precedent.

The Commission's use of a model to determine an element of a rate to recover costs is supported by OCC witness Duann. For example, Dr. Duann testified on cross-examination that when considering the pension costs of a company for a rate case that modeling is appropriate. Specifically he stated, "...pension cost is a liability into the future so you will have some actual model to estimate that cost yes." (Tr. v. IV at 525.) Dr. Duann also testified to his personal use of models in past Commission rate cases to determine the cost of equity.

> Q. Well, let me ask this, have you used—have you testified in past proceeding before the Commission where you helped determine the cost of equity?
>
> A. Yes.
>
> Q. And what did you do to determine that?
>
> A. I use different models to estimate cost.

(Tr. v. IV at 526.) Dr. Duann even testified that his use of different models in the same case to determine a cost for the same rate element that had different results did not mean the use of one model was wrong and the other model right. (Id. at 528.) The application of a model to assist the Commission in determining costs in advance is not a novel concept. As indicated by Dr. Duann and known by the Commission, the modeling of various types of costs is normally done in traditional rate cases. The remand order provides the Commission an opportunity to clarify this fact and show that the Commission's determination of the costs in this case through the use of model-based estimations is no different than what has been done in numerous cases previously decided by the Commission and approved by the Supreme Court of Ohio.

The Intervenors' second set of criticisms that the option pricing model is affected by implementation flaws that render it an unsuitable, or inaccurate, tool for estimating the Companies' POLR costs are not persuasive. First, the Commission has already concluded that

the option pricing model is a reliable and accurate method. Second, the Intervenors' criticisms regarding the implementation of the option pricing model are inaccurate and overstated. The evidence shows that the option model that the Companies have sponsored, and in particular the refined and improved constrained Black model that Company witness Thomas sponsored on remand, provides a reasonable approximation of the cost of the POLR risk that the Companies bear pursuant to their ESP. Third, the Companies' evidence of their POLR costs based upon the results of the Monte Carlo modeling provides additional and independent support that their existing POLR charges are cost-based.

1. The Commission has determined that the Black-Scholes option model (and thus, the Black option model) is a useful tool for quantifying the Companies' POLR risks and costs.

The Commission carefully reviewed the Companies' use of the unconstrained Black-Scholes option model during the original hearings in this proceeding. After a thorough review, and after considering Intervenor arguments against the model, the Commission concluded that the Black-Scholes model was an appropriate tool for quantifying the Companies' POLR risks and costs.

> With regard to the amount of the POLR charge, the Commission carefully considered all of the arguments, testimony, and evidence in the proceeding and determined that the Companies should be compensated for the cost of carrying the risk associated with being the POLR provider, including the migration risk. Based on the evidence presented, the Commission adopted the Companies' witness' testimony who quantified that risk at 90 percent of the estimated POLR costs, using the Block-Scholes model (see Tr. v. XIV at 204-205; Cos. Ex. 2-E at 15-16; Cos. Ex. 1, Exhibit DMR-5). The parties have not raised any new issues for the Commission's consideration. Therefore, we deny rehearing regarding the various POLR issues that have been raised.

Entry on Rehearing, at ¶ 76.

Although it provides the most compelling rebuttal to arguments by Intervenors who contend that the Black-Scholes option model is not suitable for the purpose to which the

Companies have used the model, the Commission's approval of the model is not the only support for it. For example, while it had not independently verified the POLR charges that the Companies had proposed to implement based on the Black-Scholes model, the Ohio Energy Group (OEG) agreed that the Companies' option modeling approach to pricing POLR service "may be reasonable in concept." (OEG's Initial Brief at 17.) On remand, OCC cites to its witness, Emily Medine from the initial phase of this proceeding, to assert the Black-Scholes model is an untested and unproven tool to calculate a POLR charge (OCC Initial Brief at 24.). However, the Commission need look no further than Ms. Medine's audit report in the Companies' 2010 fuel adjustment clause proceedings, Case No. 10-268-EL-FAC, et al.[6], where she notes, at page 3-22, note 19, that "[t]he standard industry tool to evaluate an option is the Black-Scholes model."

The point is that the Commission already has determined that the Black-Scholes option pricing model is an appropriate tool for quantifying POLR risks and costs. Moreover, contrary to Intervenor arguments, the Supreme Court did not hold that the unconstrained Black-Scholes model, the constrained Black model, or any other particular model, may not be used to quantify POLR costs. What the Court held is that if the Commission is going to retain the Companies' current POLR charges, it needs to supplement the record in order to provide support for the finding that the charges are based on costs and are not based simply on what customers are willing to pay for the optionality or that the charges are reasonable even though not based on cost. Remand Decision at ¶ 30. As the Companies explained in greater detail in their Initial

[6] The citation to that open Commission docket is illustrative of the acceptance of the Black Scholes model by an Intervenor witness that previously found fault with the model. The Commission can weigh the significance of this point as it sees fit, but the Companies would argue that the usage of the statement from the initial phase of the hearing by OCC witness Medine opened the door to the work done on behalf of the Commission that contradicts this earlier statement. To the extent the Commission would rely on this point the Companies seek administrative notice of that Commission ordered audit report in the Commission docket.

Brief, at pages 17-24, they have provided supplemental evidence, through the testimony of Dr. Makhija, Dr. LaCasse, and Ms. Thomas, which confirms that both the unconstrained Black-Scholes and the constrained Black option models quantify the Companies' costs of providing the POLR optionality pursuant to their ESP. Accordingly, the Commission now has a sound evidentiary basis, which meets the Court's directive on remand, to rely upon the Companies' option models to quantify their POLR risks and to support their existing POLR charges. It also has, as additional evidence that may be used either to confirm the results of the option modeling or as a separate and independent basis, the Monte Carol modeling results.

2. Intervenor criticisms of the Companies' implementation of the Black option model are inaccurate or overstated.

On remand the Companies, through witness Thomas, have sponsored and recommend that the Commission rely upon the constrained Black option model to quantify their POLR risks and costs and to support the retention of their existing POLR charges. The Companies explained in some detail in their Initial Brief, at pages 39-43, the improvements and refinements of the constrained model. Among the refinements and improvements, the constrained model incorporates the restrictions on customer switching approved by the Commission and included in the Companies' tariffs. It also reflects changes in pricing that occur over the term of the ESP that the Commission approved as well as the market prices relied upon by the Commission. The original unconstrained model assumed (conservatively) that the first year ESP would remain in effect for the entire ESP term. In addition, the constrained model is based on a series of options, not just a single option (as was the case with the original unconstrained model) that are exercisable monthly over the term of the ESP. This refinement allows the model to reflect the possibility that a customer may leave and then return to the ESP's SSO during the term of the plan. (Cos. Remand Ex. 4 at 14.)

As is often the case when an advocate does not agree with estimates of quantities being measured, in this instance POLR costs, the advocate will try to find fault with the estimation technique, in this instance the constrained Black option model (or the constrained Black-Scholes model). If enough purported flaws can be advanced, the opponent hopes to undermine the model and, thus, the estimates it produces. However, the issue is not whether the model used to make the estimates perfectly represents the real world situation being modeled. Rather, the issue is whether it provides a reasonable approximation.

Intervenors begin by pointing out that the Companies' option models assume perfectly competitive markets and rational behavior by customers acting in their economic self-interest. They claim that, in fact, the market for retail generation service is not perfectly competitive and that customers do not always act rationally. (IEU Brief at 34; OCC Brief at 25-26.) This is not a flaw in the Companies' option modeling, let alone a basis for rejecting it. All economic modeling makes the same types of assumptions, and in all cases the markets being modeled may have competitive imperfections and market participants may, in some instances, not act rationally. Accordingly, Intervenor criticisms in this regard are really just arguments that the Commission should never rely on economic models to develop cost estimates. The question, though, is whether the assumptions of competitive markets and rational consumer behavior are reasonable. Dr. LaCasse explained that those are reasonable assumptions to make for this and all other economic models.

Non-Price Factors Affecting Customer Behavior

Intervenors contend that the Companies' POLR cost modeling does not take into account non-price factors that affect customer behavior such as customer inertia, customer loyalty, the time to review and sign contracts, as well as other customer behavior factors. (IEU Brief at 34;

IEU Remand Ex. 2 at 13-14; OCC Brief at 26, OCC Remand Ex. 1 at 20.) Companies' witness Thomas responded to these criticisms. Ms. Thomas explained that, in general, these types of non-price factors are behavioral factors that will vary by individual customer and the Companies have no way of knowing this information for a given customer, let alone for all customers. She also noted that there are offsetting factors as well. For example, under opt-out aggregation, large numbers of customers will switch at once. Under opt-out aggregation, customers will be switched to a CRES provider unless they take specific action to opt out and choose not to be switched. In such cases, there will be customers who end up switching that would not have done so independently, thereby creating an offset to the non-price factors that the Intervenors cite. Ms. Thomas also reported that such out-out aggregation activity is continuously increasing for the Companies. (Cos. Remand Ex. 8 at 5.)

Besides community aggregation, Ms. Thomas testified that there are also other customers that will switch just because they can or because they will receive other benefits or services beyond the price of generation from a CRES provider, these factors operate to offset any perceived limitations on shopping relied upon by Intervenors. (*Id.*)

Accordingly, Ms. Thomas concluded the Companies' approach, for modeling purposes, was to assume customers would be price responsive. Non-price factors, which work in both directions, are not known and therefore properly were not modeled. (*Id.* at 6.)

Switching Constraints

IEU also contends that the Companies modeling does not appropriately reflect the restrictions on customers switching back to the ESP SSO that result from the terms and conditions of customers' contracts with CRES Providers. (IEU Remand Ex. 2 at 14.) Ms. Thomas explained that this refinement simply is not capable of incorporation into the

Companies' modeling. She observed that the Companies are not privy to the terms and conditions of contracts between a customer and their specific CRES provider. The Companies only know when the customer has provided the Companies with notice of switching, but have no further information as to the term of the contract or the provisions that may hold either the customer or the CRES supplier to that term. For example, the Companies do not have information as to provisions that allow either the customer or the supplier to end the contract, any provisions by which a supplier may return the customer to the SSO or any contract provisions which might cause the customer to seek to otherwise modify their contract due to price changes or other reasons. Ms. Thomas stated that the circumstances an outcome of such developments will vary by both customer and CRES provider and are not known to the Companies. (Cos. Remand Ex. 8 at 6.)

Accordingly, in its determination of the cost of providing POLR service, the Companies quantified those factors which it knows and it did not quantify other factors which it does not and will not know. (*Id.*)

Ms. Thomas also addressed the criticism by IEU, at page 12 of IEU Remand Ex. 2, that the Companies' constrained model does not properly reflect the fact that the Companies' switching rules require, for certain commercial and industrial customers, that they must provide a minimum of 90 days' notice before switching to a CRES provider. Ms. Thomas responded that this requirement is implicitly accounted for in the Companies' determination of their POLR cost. She explained that when customers provide a 90-day notice to switch suppliers, they have made a decision based on forward-looking information regarding the pricing, terms and conditions that they may be served under by a CRES provider. She also pointed out that, on the other hand, even after a customer provides a 90-day notice, they may or may not end up actually switching to

a CRES provider in 90 days. This could occur sometime after 90 days or not at all because the notice is distinct from the actual enrollment. Because the model assumes that customers will switch when it is in their economic interest to do so, this is consistent with the assumption that customers have provided the 90-day notice because they have enough forward-looking information to determine that it is in their economic interest to switch suppliers and provide notice of switching in a timely manner to advance their self interest. (Cos. Remand Ex. 8 at 7.)

Volatility

Several Intervenors have criticized the volatility assumption of 33.3%, based upon historical volatility data, that the Companies use as an input to their modeling. IEU and OCC contend that use of historical volatility to estimate the future volatility data is inappropriate and that implied volatilities derived from current market data should have been used instead. (IEU Brief at 36; OCC Brief at 28-29.) Dr. LaCasse disagreed with this criticism. She explained, and even IEU witness Lesser conceded, that historical volatility is a predictor of future volatility (Cos. Remand Ex. 5 at 3; IEU Remand Ex. 1 at page. 21, lines 8 – 9.)

Dr. LaCasse explained that there is no single accepted method for calculating the volatility used as input to an option valuation modes. She testified that practitioners use historical volatility, implied volatility, and sometimes develop their own proprietary methods to blend both historical and implied volatilities, citing Dr. Rajna Gibson's text *Option Valuation*, at pages 114-120, to support that point:

> "one method of computing the future ... variance (σ^2) is to simply rely on past data; that is, to assume that this past variability... is indeed invariant over time...[7]

Dr. LaCasse also refuted the proposition, advanced by IEU and Dr. Lesser, that use of implied volatility data is always a more accurate predictor of future volatility than historical

[7] Gibson, Rajna. Option Valuation: Analyzing and Pricing Standardized Option Contracts. McGraw-Hill New York, 1991.

volatility data. She explained that in thinly traded option markets, which is the category in which POLR options would fall, as opposed to highly liquid options market, historical volatility data may be a more accurate predictor than implied volatility. (Cos. Remand Ex. 5 at 3-4.)

Intervenors and Staff also have argued that, in any event, the 33.3% volatility value that the Companies have used is overstated because, they contend, the 33.3% volatility value, which is derived from data regarding the energy component of the wholesale market price, does not necessarily apply to non-energy components of that price. (IEU Brief at 36; OCC Brief at 29; Staff Brief at 5.) The Companies addressed this point in their Initial Brief, at pages 48-50. Application of the 33.3% volatility value to the entire market price is appropriate because the 33.3% value is, itself, a conservative and understated estimate of the volatility of the energy component of the market price (Cos. Initial Brief at 50.) In addition, many of the remaining components of the market price are also energy related, (Staff Remand Ex. 1 at 3), so it is appropriate to apply the energy volatility value to them directly.

In any event, in the course of reviewing the use of the Companies' Black-Scholes option model after the initial hearing in this proceeding, the Commission necessarily reviewed and approved the 33.3% volatility value the Companies have used in this case. Opinion and Order, at pages 38-40 (March 19, 2009); Entry on Rehearing, at pages 24-17 (July 23, 2009).

Strike Price

IEU contends that the model incorrectly assumes that the strike price is constant during the term of the ESP. (IEU Brief at 35.) Ms. Thomas explained that the original unconstrained Black-Scholes model assumed a constant ESP (or strike) price based on the first year ESP price. She further explained that the refined and improved constrained option model incorporated the price increases that the ESP authorized. (Cos. Remand Ex. 4 at 13; Tr. v. II at 242-244.)

Consequently, IEU's criticism is incorrect with respect to the constrained version of the model, which the Companies rely upon on remand to support their existing POLR charges. And, even with respect to the original unconstrained Black-Scholes option model, IEU's criticism misses its mark. The assumption in the original unconstrained modeling that the ESP price would remain fixed at the first-year level, instead of increasing, as the ESP actually provides, was a conservative assumption. That is, the assumption of a fixed, rather than increasing, ESP (or strike) price produced lower POLR costs and, thus, lower charges than would have resulted from incorporating the ESP price increases that occurred after the first year of the plan.

Date Issues

OCC believes that the Companies made two date errors. First, OCC believes that the Companies used a 41-month period for the term of the option, instead of the 36-month term of the ESP. Second, OCC thinks that the Companies have calculated the cost of options that may be exercised after the end of the ESP term. (OCC's Brief at 29-30.) OCC is mistaken on both counts. With regard to the first issue, Ms. Thomas explained in her rebuttal testimony that "the constrained model computes a cost per kWh that appropriately reflects the term of the ESP." (Cos. Remand Ex. 8 at 12.) She described in substantial detail the constrained model, at page 8 – 11 of her rebuttal testimony. (Id.) She makes clear that the monthly options used in the constrained model begin at the first month of the ESP and end 36 months later, at the last month. (Tr. v. II at 244.)

Ms. Thomas's testimony also confirms that the term of the options analyzed by the constrained model did not extend past the end of the ESP's term. She notes at page 9 that "customer choices [i.e., options] are analyzed over the entire term." (Cos. Remand Ex. 8 at 9;

Tr. v. II at 244.) There is simply no basis for OCC's assertion that the constrained option model evaluates options whose exercise date extends beyond the 36 month term of the ESP.[8]

Changes in POLR Costs In Relation to SSO Price Changes

OCC believes that the Black model produces nonsensical results as the SSO price declines toward the level of the market price. (OCC Brief at 33-34.) What is nonsensical is the circumstance that OCC hypothesizes. The Companies' constrained Black option model is run at the time the Companies make their commitment to an ESP. In order for an ESP to be possible, the Companies' ESP commitment provides prices that begin and are expected to remain, in the aggregate, over the term of the ESP at levels below what a market rate offer alternative would provide. In other words, the ESP pricing at the outset, and over the term of the ESP, is expected to be below market. In that circumstance no rational customer would be taking service from a competitive alternative when the Companies make their ESP commitment and run the model. OCC's example assumes that customers are irrationally taking service, at the outset, at higher market prices than the ESP SSO prices. The flaw is not in the Black model, but in the nonsensical ESP pricing that OCC's hypothetical assumes.

The Black Model Assumption Regarding SSO and Market price Differences

The constrained Black option model examines differences between the ESP SSO prices and possible future retail market prices. In financial terms the customers' POLR option rights in the context of an ESP are equivalent to a series of options to buy power at the ESP price. Rational customers will exercise their rights to change providers when the economic benefits are apparent. On the other side of the transaction, however, the Companies bear the difference

[8] Nor is there any record basis for OCC's belief that the term of the option used in the original unconstrained model extended past the end of the ESP term or that the term of the option used in the unconstrained option was different than the 36-month ESP term. In any event, the Companies rely principally upon the improved and refined constrained option model on remand to support their POLR charges .

between ESP prices and lower market prices as a loss. (Cos. Ex. 2A at 30-31.) OCC contends that the model's assumption that the Companies would sell the generation that switching customers no longer purchase from the Companies at the competitive retail price is flawed. OCC contends that:

> 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"). 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.

(OCC's Brief at 35.)

In other words, OCC thinks that, in the event of shopping, the Companies will recover less than the retail market price that their option model assumes. If so, that means that the model underestimates the POLR risks and costs and, thus, <u>understates</u> the appropriate POLR charges. OCC's argument serves only to highlight yet another manner in which, if anything, the Companies' option model produces conservative estimates of their POLR costs and charges.

3. The Monte Carlo modeling sponsored by Dr. LaCasse on rebuttal confirms the results of the Companies' option modeling and provides an independent cost basis for their existing POLR charges.

OCC continues to argue that the Monte Carlo cost modeling that Dr. LaCasse presented in her rebuttal testimony was improper rebuttal testimony and the Commission should not consider it. (OCC Brief at 21-23.) OCC made a motion to strike this testimony, and the Monte Carlo model cost estimates that Dr. LaCasse sponsored, at the hearing. The attorney examiners heard arguments by OCC and other parties in support of the motion, listened to the Companies' arguments in opposition to the motion, and after considering all of the arguments denied OCC's motion. OCC did not take an interlocutory appeal of the ruling. Accordingly, the attorney

examiners' ruling may not be attacked on brief, and the Commission should reject OCC's argument to exclude this proper rebuttal evidence.

II. THE COMMISSION SHOULD RE-AFFIRM ITS CONCLUSION THAT THE COMPANIES' ENVIRONMENTAL INVESTMENT CARRYING CHARGES ARE PROPERLY RECOVERED IN THE COMPANIES' ESP.

The Companies and Staff agree that Ohio Rev. Code § 4928.143(B)(2)(d) provides statutory authority for the Commission's decision to allow the Companies to recover the capital carrying costs that will be incurred during the ESP period on incremental 2001-2008 environmental investments that were not previously reflected in the Companies' existing rates. IEU and OCC dispute this position on the grounds that any carrying costs allowed under division (B)(2)(d) must "have the effect of stabilizing or providing certainty regarding retail electric service. " OCC argues, and IEU apparently assumes, that the perspective of the statute is exclusively on the benefits to the customers and not the Companies. (OCC Brief at 41: IEU Brief at 14.) Intervenors' positions are legally and factually wrong.

Division (B)(2)(d) does indeed speak to terms, conditions and charges, including "carrying costs" that have "the effect of stabilizing or providing certainty regarding retail electric service," but there is nothing in the statute that requires this predicate effect to be viewed only from the perspective of the customer and never from the perspective of the Companies. Indeed, the sole authority OCC cites to support its one-sided view of the statute supports a broader reading of the statute. OCC states that "[t]he 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.'" (OCC Brief at 41, n. 139, citing In re FirstEnergy RSP Application, Case No. 03-1461-EL-UNC, Entry at 4-5, ¶9 (Sept. 23, 2003)). Yet in its argument, OCC ignores

completely the Commission's reference to "financial stability for the [EDUs]," and sees only the reference to "rate certainty." Even accepting OCC's apparent ability to divine unrecorded legislative history and accepting its representation that division (B)(2)(d) was influenced by the Commission's support for rate stabilization plans, however, the conclusion OCC seeks does not follow because the Commission's support for rate stabilization plans did include a clear acknowledgement of the need to provide financial stability for the EDUs as well as rate certainty for the customers. The Commission also has taken that broader view of the ESP statute in this very case. As noted before, in its ESP Order, the Commission expressly recognized that the statute directs the Commission to balance rate certainty for the customers with stability and revenue certainty for the Companies. ESP Order at 72.

IEU also wrongly suggests that there is no record support for the conclusion that recovery of the carrying cost for prior environment investments will have a stabilizing effect on retail electric service. That testimony was given in the prior hearing and remains part of the record in this case. Companies' witness Nelson explained that the carrying charges will recover the ongoing costs of investments in environmental facilities and equipment that are necessary to keep the Companies' low-cost coal-fired generation units running. The customers benefit because the operating costs of these units remain well below the cost of securing the power on the market, and the Companies are passing the lower-cost power through the FAC. (Cos. Ex. 7B at 7.) Thus there is express statutory support, and record support, for the Companies' and Staff position.

The recovery of the incremental environmental investment carrying charges is also authorized by Ohio Rev. Code §4928.143(B)(2)(e), which allows for automatic increases in any component of the Companies SSO. As the Commission noted in its ESP Order environmental

investment carrying charges were included in the Companies' SSO rates prior to the adoption of the ESP as a result of the Commission's decision in the Companies' rate stabilization plan cases, ESP Order at 28; the carrying charges included in the ESP are merely the carrying charges on investments incremental to those already reflected in rates. IEU's argument that division (B)(2)(e) cannot be invoked unless the component is separately eligible for inclusion in an ESP (IEU Brief at 14) has no merit because if the component has to be expressly authorized elsewhere in the statute there would be no need for subsection (B)(2)(e) at all. IEU's argument violates the fundamental rule of statutory construction that every provision is intended to have meaning.

The recovery of the approved carrying charges also is authorized under division (B)(2)(b) of the statute, which expressly allows for the inclusion of environmental expenditures incurred after January 1, 2009. While IEU and OCC argue that the incremental environmental investment carrying charges at issue here do not fall within the permissible ESP period, the Commission has already determined otherwise. ESP Entry on Rehearing at 12. IEU's additional arguments that the other pre-conditions of division (B)(2)(b) are not satisfied here has no merit. IEU misreads the statute. The conditions for including an allowance for construction work in progress or an allowance for generating facility construction do not apply to environmental expenditures and would not apply to carrying charges related to environmental expenditures.

III. THE REMEDIES INTERVENORS SEEK ARE UNLAWFUL.

A. Even if the Commission adjusts the charge for the remainder of the ESP term, the charges collected prior to the Remand Decision were lawful.

Throughout this proceeding, IEU has referred to AEP Ohio's pre-remand recovery of POLR charges and environmental investment carrying costs as "unlawful." In its Initial Remand Brief, for example, IEU asserts that "[a]s things presently stand, the POLR charge [in AEP

Ohio's tariff] is unlawful[.]" (IEU Brief at 6.) IEU similarly asserts that "the Supreme Court . . . found the POLR charge and the environmental investment revenues to be illegal[.]" (Id. at 48.) These charges blatantly mischaracterize the Ohio Supreme Court's Remand Decision and Ohio law.

The Court did not find that AEP Ohio's POLR charge and recovery of environmental investment carrying costs was illegal. To the contrary, the Court explicitly withheld judgment on the lawfulness of the POLR charge, stating:

> To be clear, we express no opinion on whether a formula-based POLR charge is per se unreasonable or unlawful, and the commission may consider on remand whether a non-cost-based POLR charge is reasonable and lawful. Alternatively, the commission may consider whether it is appropriate to allow AEP to present evidence of its actual POLR costs.

Remand Decision at ¶ 30. The Court also withheld judgment on the legality of AEP Ohio's recovery of environmental carrying costs, remanding that issue and authorizing the Commission to "determine whether any of the listed categories of [R.C. 4928.143](B)(2) authorize recovery of [such] charges." *Id.* at ¶ 35. If the Court had truly determined that AEP Ohio's recovery of POLR charges and environmental investment carrying costs was "unlawful," as IEU asserts (IEU Brief at 44), those issues would not be before this Commission on remand.

As a matter of law, AEP Ohio's recovery of POLR charges and environmental investment carrying costs was lawful – they were recovered pursuant to a Commission-approved tariff. To quote an earlier opinion of the Ohio Supreme Court:

> In the present case we have rates which were established by the proper designated authority after a hearing and consideration in full compliance with the law, and, until such time as they were set aside by the Supreme Court, they were . . . the lawful rates and the *only* rates which could be collected by the utility.

Keco Industries, Inc. v. Cincinnati & Suburban Bell Tel. Co. (1957), 166 Ohio St. 254, 258, 141 N.E.2d 465. Put differently, "any rates set by the Public Utilities Commission are the lawful

rates until such time as they are set aside as being unreasonable and unlawful by the Supreme Court[.]" *Id.* at 259. AEP Ohio's collection of POLR charges and of base generation rates that included carrying costs on AEP Ohio's incremental 2001-2008 environmental investments, per the Commission's March 18, 2009 Opinion and Order and July 23, 2009 Entry on Rehearing, was therefore lawful.

B. The adjustment to deferrals proposed by Intervenors is prohibited retroactive rate making.

Proceeding from the false premise that AEP Ohio's Commission-approved collection of POLR charges and recovery of incremental environmental investment carrying costs was "unlawful," IEU (along with OCC and OPAE) recommends that "the total authorized revenue that was deferred for collection [under the ESP] . . . be reduced by an amount equal to that portion of the revenues . . . that the Supreme Court has determined are unlawful." (IEU Brief at 43-44.) This request for relief relies on the Fuel Adjustment Clause (FAC) mechanism in AEP Ohio's ESP. The Commission ordered that AEP Ohio's new rates be phased in over the term of the ESP. This was accomplished by "deferring a portion of AEP Ohio's annual incremental FAC costs" over the course of the ESP. ESP Order at 20. "The amount of the incremental FAC expense that [was] recovered from customers [was] limited so that total bill increases [would] not" exceed certain caps. (Id.) The deferred FAC expenses were then to be recovered over seven years after the term of the ESP through a non-bypassable surcharge. (See id. at pp. 20, 22-23.)

OCC and OPAE assert that, "because the Companies were permitted to collect ESP rates that included unjustified charges, the resulting deferrals that are yet to be collected from customers have been overvalued on a dollar-by-dollar basis associated with [the purportedly] unjustified POLR and environmental expenses." (OCC and OPAE Brief at 45-46.) In other

words, because AEP Ohio recovered more than Intervenors assert it should have, AEP Ohio deferred more than Intervenors assert it should have. (See id.; see also IEU Brief at 43.) To remedy this, OCC, OPAE, and IEU assert that the "unjustified charges [should] be returned to customers" by "re-calculat[ing] the amount of fuel expenses deferred and to be collected from customers." (OCC Brief at 46; see also IEU Brief at 43-44 ("the deferred revenues must be reduced by an amount equal to that portion of the revenues authorized by the Commission . . . that the Supreme Court has determined are unlawful").)

As AEP Ohio has already explained in numerous filings in this proceeding, restitution is not an available remedy. "[T]he remedy provided by law" for a purportedly unlawful rate increase is to seek a stay and post a bond, per Ohio Rev. Code § 4903.16. In re Application of Columbus S. Power Co., 128 Ohio St.3d 512, at ¶ 20. That is *the* manner in which Ohio's "statutes protect against unlawfully high rates[.]" Id. at ¶ 17. No Intervenor took advantage of this option. A refund is prohibited because Ohio law prohibits retroactive ratemaking. *See id.* at ¶¶ 15-16.

OCC argues that the Ohio Supreme Court creates an exception to the general prohibition against retroactive ratemaking "if there is a mechanism built into the rates that allow[s] for prospective rate adjustments[.]" (OCC and OPAE Brief at 47 (footnote omitted).) And, according to OCC, there is such a mechanism in AEP Ohio's ESP – "[t]he phase-in deferrals[.]" (*Id.*) IEU goes further, arguing that Ohio Rev. Code § 4928.144 and the Commission's ESP Order *require* the Commission to restate what it refers to as the deferred revenue balance. (IEU Brief at 44.) These arguments mischaracterize the FAC cost deferral mechanism established in the Commission's ESP Order.

There is no mechanism built into AEP Ohio's ESP to adjust AEP Ohio's collection of deferred FAC Costs. The ESP Order explained that "Section 4928.144, Revised Code, . . . mandates that any deferrals associated with the phase-in authorized by the Commission *shall be collected* through an unavoidable surcharge." ESP Order at 22 (emphasis added). Accordingly, the Commission held that "[a]ny amount over the allowable total bill increase percentage levels will be deferred . . . with carrying costs[,]" and "any deferred FAC expense balance remaining at the end of 2011 *shall be recovered* via an unavoidable surcharge." (*Id.* at pp. 22-23 (emphasis added).) The Commission further held that "the collection of any deferrals, with carrying costs, . . . *shall occur* from 2012 to 2018[.]" (Id. at p. 23 (emphasis added).) Thus, the FAC mechanism did not "allow for prospective rate adjustments," as OCC asserts. (OCC and OPAE Brief at p. 47.) To the contrary, AEP Ohio's recovery of its deferred FAC expense balance is mandatory, under both the Commission's ESP Order and Ohio Rev. Code § 4928.144.

IEU asserts that "[t]he Commission itself recognized . . . that the deferrals booked by the Companies were not sacrosanct," pointing to provisions in the Commission's ESP Order that required AEP Ohio to "phase-in any *authorized* increases so as not to exceed" the rate increase caps and defer "[a]ny amount over the *allowable total bill increase* percentage levels[.]" (IEU Brief at 48, quoting ESP Order at 22 (emphasis in IEU Brief).) That is revisionist history. There is no question that the phased-in rate increases that occurred before the Ohio Supreme Court's remand decision were "authorized" by the Commission. There is also no question as to what the "allowable total bill increase percentage levels" were. Authorized increases were capped at 7% for CSP and 8% for OP in 2009, 6% for CSP and 7% for OP in 2010, and 6% for CSP and 8% for OP in 2011. (Id.) When the Commission held that "[a]ny amount over the allowable total bill increase percentage levels will be deferred" (*id.*), it meant that any amount *over the yearly*

rate increase caps would be deferred. Nothing in the Commission's Opinion and Order allowed, must less required, a redetermination of AEP Ohio's deferred FAC expenses after they had already been deferred.

The Commission ESP Order stated that any deferred FAC expense balance "*shall be recovered.*" ESP Order at 22 (emphasis added). Section 4928.144 of the Ohio Revised Code similarly states that any incurred costs that are deferred to allow the phase-in of an electric distribution utility rate "shall" be collected "through a nonbypassable surcharge on any such rate or price so established[.]" Ohio Rev. Code § 4928.144. Recalculating the deferred FAC expenses would violate Section 4928.144. IEU's argument, if accepted, would seriously undermine the ability of public utilities in Ohio to implement expense deferral accounting mechanisms in the future. It would call into question whether Commission expense deferral orders could be relied upon and, as a result, would call into question whether the deferrals themselves were legitimate in the first place. Such a result would conflict with §§ 4928.144, 4928.143(d) and 4928.143(f). IEU's argument must be rejected.

C. The POLR charge is already a bypassable charge at the customer's option.

Constellation Energy accuses AEP Ohio of applying the POLR charge as a nonbypassable charge contrary to the ESP Order. (CE Brief at 14.) Constellation argument merely repeats the direct testimony of its witness David Fein. That testimony was discredited on cross-examination. Mr. Fein admitted that his belief that AEP Ohio was advising customers that by electing to waive the POLR charge the customer was waiving its right to take service under the SSO for all time was based on nothing more than double hearsay – what he heard from some unidentified suppliers about what some unidentified customers might have told them. (Tr. v. II at 409, 412-413.) Mr. Fein was confronted with the Companies' actual notice to customers. (Id. at 409-411.) While Constellation's position apparently has not changed, the Commission can

read the notice for itself. Constellation has given the Commission no reason to think that AEP Ohio is not appropriately implementing the ESP Order with respect to the customer's right to waive the POLR charge by agreeing to pay a market price if the customer returns "prior to the end of 2011 for any reason." (Id. at 410.)

D. If any refunds are determined to be owed, the Companies should pay only 3% interest – a generous interest rate, higher than any customer could have earned during this period.

Various Intervenors have requested that any amounts collected subject to refund under the ESP be refunded "with appropriate interest for the time value of the customers' money." (IEU Brief at 42.) According to OCC, a "reasonable" amount of interest to apply to these interests would be 10.93%. OCC based this rate on the interest rate that applies "for calculating the carrying cost on phase-in FAC deferral balance." (OCC and OPAE Brief at 43, quoting OCC Remand Ex. 2 at 29.) OCC's witness, Daniel J. Duann, Ph.D. CRRA, notes that this interest rate "is the gross-of-tax weighted average cost of capital based on a 50/50 capital structure of equity and long term debt with a return on equity of 10.5% and the actual cost of long term debt (5.34%)." (OCC Remand Ex. 2 at 29.) However, the costs of capital and long-term debt are completely irrelevant to determining a reasonable rate for a utility customer to earn on a utility bill over-payment.

Given the minimal interest rates that are available to consumers in this difficult economic climate, awarding AEP Ohio's customers a 10.93% interest rate on any refunds under the ESP would be absurd. As AEP Ohio Witness Nelson testified, the minimum rate applied to customer deposits set out in Chapter 4901:1-17-05 of the Ohio Administrative Code – 3% – is a much more appropriate rate. (Cos. Remand Ex. 2 at 5.) Indeed, this is a much higher rate than customers could find on the market if they were looking for a short-term investment. The six-

month CD rate is approximately 0.59%. Twelve-month CDs offer rates of approximately 0.93%. (Tr. v. I at 80.) Paying 3% interest on any refunds determined to be owed to AEP Ohio's customers would more than compensate those customers for the short-term loss of their funds.

CONCLUSION

The Commission should reaffirm its prior decisions regarding the POLR charges and environmental investment carrying costs. The record, as supplemented through this remand proceeding, ably demonstrates why the charges are lawful and reasonable and why the Intervenors' contrary positions should be properly rejected again.

Respectfully Submitted,

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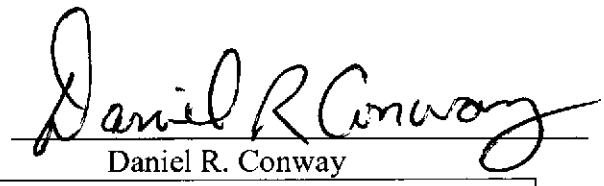
CERTIFICATE OF SERVICE

The undersigned hereby certifies that a true and correct copy of the foregoing Columbus Southern Power Company's and Ohio Power Company's Initial Merit Brief has been served upon the below-named counsel and Attorney Examiners via electronic mail this 12th day of August, 2011.



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