BEFORE

THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Fuel Adjustment Clauses for Columbus Southern Power Company and Ohio Power Company.	)))	Case No. 09-872-EL-FAC Case No. 09-873-EL-FAC

OPINION AND ORDER

The Public Utilities Commission of Ohio, having considered the record in these matters and the stipulation and recommendation submitted by the signatory parties, and being otherwise fully advised, hereby issues its opinion and order.

APPEARANCES:

Steven T. Nourse, One Riverside Plaza, Columbus, Ohio 43215-2373, and Daniel R. Conway, Porter, Wright, Morris & Arthur, LLP, 41 South High Street, Columbus, Ohio 43215, on behalf of Columbus Southern Power Company and Ohio Power Company.

Mike DeWine, Ohio Attorney General, by William L. Wright, Section Chief, and Werner L. Margard and Thomas W. McNamee, Assistant Attorneys General, 180 East Broad Street, Columbus, Ohio 43215, on behalf of the Staff of the Public Utilities Commission.

Janine L. Migden-Ostrander, Ohio Consumers' Counsel, by Maureen Grady, Melissa Yost, and Kyle Lynn Verrett, Assistant Consumers' Counsel, 10 West Broad Street, Suite 1800, Columbus, Ohio 43215, on behalf of the residential utility consumers of Columbus Southern Power Company and Ohio Power Company.

McNees, Wallace & Nurick, by Samuel C. Randazzo, Joseph Clark, and Joseph Oliker, Fifth Third Center, Suite 1700, 21 East State Street, Columbus, Ohio 43215, on behalf of Industrial Energy Users of Ohio.

OPINION:

I. Background

Columbus Southern Power Company (CSP) and Ohio Power Company (OP) are public utilities as defined in Section 4905.02, Revised Code, and, as such, are subject to the jurisdiction of this Commission.

On March 18, 2009, the Commission issued its Opinion and Order in CSP's and OP's (jointly, AEP-Ohio or Companies) electric security plan (ESP) cases (ESP Order).[1] By entries on rehearing issued July 23, 2009, and November 4, 2009, the Commission affirmed and clarified certain issues raised in AEP-Ohio's ESP Order. In the ESP Order, the Commission approved fuel adjustment clauses (FAC) for the Companies including an annual audit of the FAC. Further, in the ESP cases, the Commission authorized 2010 rate increases of six percent for CSP and seven percent for OP and 2011 rate increases of six percent for CSP and eight percent for OP.

Pursuant to the Commission entry issued January 7, 2010, in Case Nos. 09-872-EL-FAC and 09-873-EL-FAC (2009 FAC cases), Energy Ventures Analysis, Inc., (EVA) was selected to perform AEP-Ohio's FAC audit for 2009. In accordance with the request for proposal, EVA is performing the audits for 2010 and 2011, unless the Commission determines otherwise. Pursuant to the request for proposal, the Commission reserves the right to rescind the award of future audits.

On May 14, 2010, both redacted and unredacted versions of EVA's management/performance (m/p) and financial audit of AEP-Ohio's FAC for 2009 (audit report) were filed in these cases. By entry issued June 29, 2010, the attorney examiner granted AEP-Ohio's motion for protective treatment regarding certain information contained in the audit report for a period of 18 months, ending on December 29, 2011.

The office of the Ohio Consumers' Counsel (OCC), Industrial Energy Users-Ohio (IEU-Ohio), and Ormet Primary Aluminum Company (Ormet) were granted intervention in the 2009 FAC cases in a Commission finding and order issued on January 7, 2010.

In accordance with the attorney examiner's June 29, 2010, entry, the hearing was held in these matters on August 23 and August 24, 2010, at the offices of the Commission. At the hearing, AEP-Ohio submitted a stipulation and recommendation (Ormet stipulation) which was filed in these dockets on August 23, 2010, and signed by the Companies, Staff, OCC, IEU-Ohio, and Ormet Primary Aluminum Corporation (Jt. Ex. 1). Additionally, at the hearing, AEP-Ohio submitted the public and rebuttal testimony of four individuals (AEP-Ohio Exs. 1 and 1A through 7 and 7A) while OCC and IEU-Ohio each offered the testimony of one witness (OCC Exs. 1 and 1A; IEU-Ohio Exs. 1 and 1A). In addition, the redacted and unredacted versions of the audit report were entered into the record without objection (Bench Exs. 1A and 1B).

As stated previously, a stipulation, signed by AEP-Ohio, Staff, OCC, IEU-Ohio, and Ormet was submitted on the record, at the hearing held on August 23, 2010. Through the stipulation, the parties agree that a determination on the collection of deferrals and

[1] *In re AEP-Ohio ESP cases*, Case Nos. 08-917-EL-SSO and 08-918-EL-SSO, Opinion and Order (March 18, 2009).

carrying charges associated with an Ormet Interim Agreement is the subject of a pending case before the Commission, *In the Matter of the Application of Columbus Southern Power and the Ohio Power Company to Recover Commission-Authorized Deferrals Through each Company's Fuel Adjustment Clause*, Case No. 09-1094-EL-FAC, and that issues associated with the Ormet Interim Agreement will be addressed in that proceeding.

On November 30, 2010, a stipulation and recommendation intended to resolve all the issues in this FAC proceeding as well as in the Companies significantly excessive earnings proceeding, Case No. 10-1261-EL-UNC *In the Matter of the 2009 Annual Filing of Columbus Southern Power Company and Ohio Power Company Required by Rule 4901:1-35-10, Ohio Administrative Code*, was filed on behalf of AEP-Ohio, Staff, the Ohio Hospital Association, the Ohio Manufacturers' Association, The Kroger Company, and Ormet. On December 16, 2010, the Companies filed a notice of withdrawal from the November 30, 2010, stipulation and recommendation thus rendering the stipulation moot.

II. Summary of the Audit Report

The audit report submitted by EVA and its subcontractor Larkin and Associates PLLC (Larkin) presents the results of the m/p and financial audit for the fuel adjustment clause which is the mechanism being used to recover prudently incurred fuel, purchased power, and other miscellaneous expenses. The FAC includes: Account 501 (Fuel); Account 502 (Steam Expenses); Account 509 (Allowances); Account 518 (Nuclear Fuel Expense); Account 547 (Non-Steam Fuel); Account 555 (Purchased Power); Account 507 (Rents); Account 557 (Other Expenses); Accounts 411.8 and 411.9 (Gains and Loses from Disposition of Allowance); and Other Accounts. EVA and Larkin (jointly, auditors) conducted this audit through a combination of document review, interrogatories, site visits, and interviews. Additionally, EVA and Larkin visited the Conesville Coal Preparation Plant and the Conesville power plant. In its initial ESP application, the Companies proposed mitigating the rate impact of any FAC increases on customers by phasing in the new ESP rates by deferring a portion of the annual incremental FAC costs such that total bill increases to customers would not exceed 15 percent during each year of the ESP. The Commission's ESP order, issued on March 18, 2009, modified AEP-Ohio's proposal to mitigate the rate impact on customers by limiting the phase-in of any FAC increases on a total bill basis by seven, six, and six percent for CSP and by eight, seven, and eight percent for OP for years, 2009, 2010, and 2011, respectively. The Commission's ESP order also stated that the collection of any deferrals including carrying costs remaining at the end of the ESP shall occur from 2012 through 2018 as necessary to recover the actual fuel expense incurred plus carrying costs. (Jt. Ex. 1 at 1-2 through 1-3; ESP order at 23.)

The audit report found that AEP-Ohio's fleet is largely coal-based and coal procurement costs are by far the largest component of the FAC. The auditors noted that since mid-2007, the coal industry has demonstrated unprecedented volatility which has resulted in utility fuel procurement personnel facing enormous challenges. Additionally, from mid-2007 until the third quarter of 2008, a global coal supply/demand imbalance increased the demand for and price of United States (U.S.) coals. In the auditors' opinion, American Electric Power Service Corporation (AEPSC) did an exceptional job during this period particularly with those suppliers that faced financial difficulties. Since the third quarter of 2008, electricity demand slowed as a result of the severe economic recession thus leading many utilities to end up with more coal under contract than needed. Thus, from mid-2007 through the end of 2008, electric utilities went from having to acquire coal under contract to having to manage a surplus of coal inventories. In the auditors' view, AEPSC also did an outstanding job managing its excess coal inventories. The auditors found this to be the case based, in part, on the treatment AEPSC afforded its suppliers, many of which were willing to defer shipments at no cost. Additionally, the auditors noted, AEPSC chose to allow stockpiles to increase rather than pay for reduced shipments which should benefit ratepayers in the long term. AEP's coal costs in 2009 were, according to the auditors, comparable to the coal procurement costs of other nearby utilities. (Jt. Ex. 1 at 1-4 through 1-5.)

The audit report further determines that, at the end of the first year of the FAC, AEP-Ohio experienced a large under-recovery. The under-recovery amounts to $37.5 million for CSP and $297.6 million for OP. The auditors note that there many components contributing to the under-recovery but that two coal contract events alone explain more than half of OP's under-recovery. The first decision attributing to the under-recovery was the decision to increase the contract price under two contracts in 2009. This surcharge under the two contracts at issue was a well-considered decision at a difficult time according to the audit report. While expensive, the auditors note that, without the surcharge, an insolvency of this coal supplier would have led to greater expense for AEP-Ohio and ultimately its ratepayers. The second contributing factor was a buy-out of a coal contract in 2007 which resulted in an increase in 2009 fuel expenses. The 2007 buy-out was structured as a Settlement Agreement arising out of contract dispute. According to the auditors, a hindsight review of such a Settlement Agreement is always difficult because its merits need to be considered at the time it was entered into. This Settlement Agreement was effectively a buy-out of the contract with this supplier after 2008. Otherwise, shipments would have continued under the contract through the ESP period. In return for agreeing to the buy-out, AEP received a settlement and a coal reserve in West Virginia. AEP booked the coal reserve as an un-regulated asset in 2008. (*Id.* at 1-5.)

The audit report further found that AEPSC's fuel procurement operation is run in a professional manner using leading industry practices in acquiring coal and transportation. To support this position, the audit report notes that AEPSC uses a portfolio strategy to purchase coal such that its market exposure at any one time is limited. Moreover, AEPSC purchases most of its coal through competitive solicitations, and AEPSC uses active management of its coal supply to match deliveries and burn where possible. The auditors noted that AEPSC was in the process of revising its fuel procurement manual to guide its practices (*Id.*)

The audit report also addresses AEP-Ohio's coal supply and scrubber retrofit at various generating facilities as well as the reduction in the need for washed coal from the Conesville Coal Preparation Plant due to the conversion of an existing coal supply agreement from unwashed coal to washed coal. The audit report notes that AEP-Ohio has met its 2009 alternative energy obligations through compliance with reduced solar obligations, the purchase of non-solar renewable energy credits (RECs) from wind and landfill gas, purchased solar (RECs), solar installations on two AEP-Ohio service centers, and wind from two purchase power agreements (PPAs). During 2009, the Companies entered into three 20-year PPAs: two for wind and one for solar. The auditors note that the resulting power prices under all three PPAs are high compared to current power prices although competitive with current market prices for renewable power. These PPAs provide no market reopeners or early outs thereby obligating AEP-Ohio to these high rates for 20 years. The auditors note that AEPSC's strategy is to continue to examine all options including self-build options (*Id.* at 1-6.) Finally, the auditors found that the quarterly FAC filings were made in a timely manner and contained sufficient documentation to support the numbers therein. However, the back-up documentation was less well organized making the audit trail more difficult. Also, the auditors reported that AEPSC was notably well-prepared and responsive to the auditors (*Id.*)

III. Management Audit Recommendations[2]

A. Auditors' Recommendations

The audit report recommends that the Commission should review whether any proceeds from the Settlement Agreement (i.e., the 2008 lump sum payment AEP-Ohio received as well as the West Virgnia coal reserve) should be credited against OP's FAC under-recovery. The auditors note that this buy-out was unique as it occurred during a period in which fuel cost recovery was not regulated yet the entire value received was for tons of coal that would have been shipped during the ESP period. The auditors do not suggest any motivation on the part of AEPSC to transfer value from ratepayers in 2009 to 2011 to an earlier date. Clearly, it was the coal supplier who initiated the Settlement Agreement because the contract price was well below market. Nonetheless, the contract was an OP asset and the value associated with it would have flowed through to OP ratepayers through the ESP period had there not been an early termination of the contract. Further, the difference between the price of the replacement coal and the contract price is

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2 The following is a summary of the recommendations from the audit report. The Commission notes that these summaries are in no way intended to replace or supplement the text of the audit report.

one factor behind the large OP FAC under-recovery. Equity suggests that the Commission should consider whether some of the realized value should be credited against the under-recovery according to the auditors. (*Id.* at 1-6; 2-21 through 2-22.)

The audit report also recommends that coal could become the new swing fuel; therefore, AEPSC should reconsider new coal procurement strategies to avoid over-commitments in the future. Further, the audit report recommends that the next m/p auditor review the Cardinal 1 scrubber situation and determine what, if any, FAC costs are due to this situation. AEPSC should also undertake a study to determine whether there is an economic justification for continuing to operate the Conesville Coal Preparation Plant. The auditors next recommend that AEPSC should finalize the update of its policies and procedures manual to reflect current business practices and that both the policies and procedures manual and the Conesville Coal Preparation Plant study should be reviewed in the next m/p audit. Lastly, the audit report recommends that prior to entering into long-term agreements for renewables with fixed pricing, AEP-Ohio should fully evaluate self-build and biomass co-firing alternatives and should explore contract options that would provide some protection in the event that the contract pricing for power and/or RECs diverge with market prices. (*Id.* at 1-7.)

B. <u>AEP-Ohio's Position on Management Audit Recommendations</u>

AEP-Ohio witnesses generally testified that the Companies are either in agreement with or not opposed to the auditor's m/p recommendations 2 through 6 found at pages 1-7 of the audit. Regarding m/p audit recommendation 2, the reconsideration of new coal procurement strategies, AEP-Ohio witness Rusk testified that the Companies agree with the recommendation and are currently undertaking such an effort (Co. Ex. 2 at 3). AEP-Ohio witness Nelson testified regarding m/p audit recommendation 3 that the Companies are not opposed to a review of the audit period operational issues concerning the Cardinal 1 scrubber in the next fuel adjustment clause proceeding (Co. Ex. 3 at 8-9). Regarding m/p audit recommendation 4, AEP-Ohio witness Rusk explained that AEPSC has already begun an effort to study the continued use of the Conesville Preparation Plant with the goal of formulating a recommendation on this facility for the next management performance audit (Co. Ex. 2 at 4). AEP-Ohio witness Rusk also testified regarding m/p audit recommendation 5. Mr. Rusk observed that AESPC is currently updating its fuel procurement policies and should have those updates in time for the next m/p audit. However, Mr. Rusk clarified that these revisions are focused on procurement policies and not focused on procurement procedures as the Companies believe that the current approach results in the efficient procurement of fuel at the lowest reasonable cost. (*Id.* at 5.) Regarding m/p audit recommendation 6, that the Companies should fully evaluate and explore self-build and biomass co-firing alternatives before entering long-term agreements for renewables with fixed pricing, AEP-Ohio witness Simmons testified the Companies are constantly exploring the most cost effective sources of renewable generation. Witness Simmons explained that bio-mass is one renewable already under consideration. The witness discussed two requests for proposal issued by AEPSC in 2010, one for bio-mass and one for a pre-blended bio-mass and coal mixture. Additionally, AEPSC is also considering other co-firing alternatives such as biodiesel. Finally, witness Simmons testified that the self-build option is being evaluated but is less likely without a clear cost recovery path. (Co. Ex. 4 at 4-6.) The sole m/p audit recommendation that generated substantial disagreement among the parties and was the primary focus of the hearing and post-hearing briefs involved m/p audit recommendation 1 discussed in detail below.

C. Disputed Management Audit Recommendation 1

Management audit recommendation 1 states that:

> EVA believes that the PUCO should review whether any proceeds from the Settlement Agreement should be a credit against OPCO's FAC under-recovery. This buy-out is somewhat unique as it occurred during a period in which fuel cost recovery was not regulated yet the entire value received was for tons that would have been shipped during the ESP period.

1. AEP-Ohio's Position

AEP-Ohio maintains that, contrary to the position of OCC and IEU-Ohio, it is important to note that the explicit language of m/p audit recommendation 1 is limited to deciding whether proceeds from the 2008 Settlement Agreement should be used to offset OP's under-recovery of fuel costs in 2009 (Jt. Ex. 1 at 1-6). The Companies explain that the proceeds of the 2008 Settlement Agreement include a lump sum payment (made in three equal payments) and a coal reserves asset located in West Virginia AEP-Ohio witness Dooley testified that a substantial portion of the lump sum payment was already credited, in part, against 2009 fuel costs flowed through the FAC with the other portion to be credited against 2010 fuel costs flowed through the FAC (Cos. Ex. 1 at 4). Moreover, according to AEP-Ohio, the present value of the undeveloped, unpermitted coal reserve is simply not known, but, in any event, the coal reserve is an OP asset that ratepayers have no claim upon. Additionally, the Companies note, the auditor clarified that the separate 2008 Delivery Shortfall Agreement was not a part of the equity issue raised in m/p audit recommendation 1. The auditor further clarified, according to the Companies, that EVA was not making a recommendation but merely felt that the Commission should consider the issue (Tr. I at 38). AEP-Ohio states that, while the auditor may have had good intentions in raising this equity issue, it would be inappropriate for the Commission to entertain the notion because it creates a host of legal issues and because the issue is susceptible to expansion of the issue as OCC and IEU-Ohio have done.

Contrary to the positions of IEU-Ohio and OCC, discussed below, the Companies, citing to the ESP Cases order at 20-22, assert that the Commission fully understood and expected that the projected magnitude of the OP fuel deferrals by the end of the ESP was approximately $550 million and the Commission built this factor into the structure of the rate cap/phase-in plan as part of the modified ESP. AEP-Ohio claims that the opportunistic positions of OCC and IEU-Ohio constitute selective and unlawful retroactive ratemaking in violation of *Keco Industries, Inc., v. Cincinnati & Suburban Bell Tel. Co.* (1957), 166 Ohio St. 254 and *Lucas Cty. Commrs. v. Pub. Util. Comm.* (1997), 80 Ohio St.3d 344. Additionally, the Companies maintain that, pursuant to the determinations made in the ESP cases and the entry in this proceeding, the audit period is for 2009 and the prudence review must be limited to 2009 fuel procurement activities. These two key Commission determinations involving operation of the FAC mechanism during the ESP were fully adjudicated and decided as part of the Commission's decision in the ESP case. Thus, these determinations are res judicata and cannot be relitigated or reapplied on a retroactive basis. See *Ohio Consumers' Counsel v. Pub. Util. Comm.* (2006), 111 Ohio St.3d 300, 318; *Ohio Consumers' Counsel v. Pub. Util. Comm.* (1985), 16 Ohio St.3d 9, 10.

Moreover, the Companies assert that the FAC baseline was a hotly contested, fully litigated issue decided in the ESP cases and cannot now be modified in this case. AEP-Ohio asserts that the Commission and the parties understood in the ESP cases that adopting a lower FAC baseline created a higher non-FAC generation rate which when coupled with the rate caps adopted as part of the modified ESP resulted in large fuel deferrals recoverable in the future through a nonbypassable surcharge on all customers in order to mitigate a larger initial rate increase. These are the same fuel deferrals OCC and IEU-Ohio are challenging at the Ohio Supreme Court claims AEP-Ohio. Since these same issues have been appealed to the Ohio Supreme Court, the Companies aver that any attempt to collaterally attack the FAC in this proceeding should not be entertained. As a final matter AEP-Ohio opines that each of the 2008 agreements raised by OCC and IEU-Ohio were prudently adopted and the Commission should not disturb any continuing effects of those agreements, especially given that each agreement was entered into by OP prior to commencement of the ESP's new FAC and before the 2009 audit period.

2. IEU-Ohio's Position

IEU-Ohio maintains that the record reflects that the Companies received benefits or value in return for the voluntarily renegotiated contracts, that the Companies accounting failed to flow through the benefits of the voluntarily renegotiated contracts, and that, as a result, customers paid more in fuel costs in 2009 than they would have had AEP-Ohio not renegotiated certain contracts. Specifically, IEU-Ohio states that the Commission should credit to customers the full benefit of the voluntary 2008 Settlement Agreement. In this regard, IEU-Ohio recommends crediting the full lump sum cash payment resulting from the 2008 Settlement Agreement rather than only a portion of the lump sum payment as the Companies have done (IEU-Ohio Ex. 1 at 6). Additionally, IEU-Ohio argues that the Commission should direct the auditor in the next m/p audit to review and provide a current valuation of the West Virginia coal reserve to be credited against OP's FAC under-recovery that AEP-Ohio will begin collecting in 2012. In the meantime, however, IEU-Ohio recommends that the Commission use the booked value of the West Virginia coal reserve to make an initial downward adjustment to the OP FAC under-recovery. (*Id.* at 7.) Crediting the booked value to the under-recovery now, claims IEU-Ohio, will ensure that customers do not pay carrying costs associated with the booked value while the Commission works to ensure a more accurate valuation of the West Virginia coal reserve. Additionally, claims IEU-Ohio, the booked reserve credit will not impact rates or harm OP's cash flow due to OP's FAC under-recovery deferral. IEU-Ohio also maintains that the Commission should credit against the OP FAC under-recovery the full value of the note receivable by the Companies for the remaining 2008 tonnage that was never delivered as a result of the 2008 Buyout Agreement (*Id.* at 5).

As an alternative recommendation, IEU-Ohio states that the Commission credit against OP's FAC under-recovery the difference between the coal contract price under the contract subject to the 2008 Settlement Agreement and the price per ton paid for the replacement coal multiplied by the number of replacement tons of coal purchased during 2009 (*Id.* at 8). The primary benefit of this option is one of administrative convenience claims IEU-Ohio as it does not require either a future auditor or the Commission to make a subsequent determination of the value of the West Virginia coal reserve (*Id.*). Adopting this option would moot the need to determine whether the full benefit of the lump sum 2008 Settlement Agreement should be credited to customers, the need to properly determine the value of the West Virginia coal reserve, and a determination of whether to credit customers for the proceeds of from the subsequent 2008 Buyout Agreement (*Id.* at 9).

The last adjustment recommended by IEU-Ohio involves a 2008 Contract Support Agreement. Under the 2008 Contract Support Agreement, CSP agreed to increase the base price for a certain tonnage of coal during 2009 with the option for CSP to acquire coal at a discount off the market price per ton for two three-year extensions of the agreement beginning in 2013. IEU-Ohio recommends that the Commission require CSP to refund the increased price per ton that AEP-Ohio agreed to pay for coal during 2009 as part of the 2008 Contract Support Agreement to its FAC customers and account for the total increase as a deferred expense with no carrying costs (*Id.* at 11-12). Should the Commission determine that carrying costs on the deferred expense are appropriate, IEU-Ohio argues that the carrying costs should be a debt-only rate. The deferred expense would then be amortized if and when CSP actually exercises the options for the respective three-year extensions of the 2008 Contract Support Agreement beginning in 2013. (*Id.*) Without this adjustment, IEU-Ohio claims that the present customers incurred higher costs for coal in 2009 but have no assurance that they will receive any of the future benefits. IEU-Ohio concludes by noting that its recommendations more fairly balance the benefits and costs associated with the coal supply contracts.

In response to AEP-Ohio's case-in-chief, IEU-Ohio urges the Commission to direct the Companies to provide its customers the benefits due them from the voluntary coal contract negotiations. IEU-Ohio also took issue with the Companies' claims that the relief requested by the intervenors and by Staff involves retroactive ratemaking and is prohibited under *Keco* and *Lucas Cty*. *Keco* is inapplicable, argues IEU-Ohio, as that case involved traditional regulation and did not involve issues associated with a self-reconciling automatic adjustment clause. Even if the Commission were to find some credibility in AEP-Ohio's argument, IEU-Ohio maintains that the Commission could easily remedy that situation by merely repricing the coal as outlined in the testimony of IEU-Ohio witness Hess (*Id.* at 7-8).

IEU-Ohio also urges the Commission to reject the Companies' claims that the Commission is merely limited to looking at fuel procurement activities during calendar year 2009. IEU-Ohio notes that AEP-Ohio's own witness acknowledged that in conducting the 2009 audit that it was necessary for the auditor to determine whether contracts entered into prior to the audit period had any impact on audit period costs (Tr. I at 162-163). AEP-Ohio's claims of res judicata are also suspect, IEU-Ohio avers, as neither claim preclusion nor issue preclusion, two necessary components of res judicata, apply in this instance. IEU-Ohio next takes issue with the Companies' position that the parties are attempting to illegally relitigate the FAC baseline established in the ESP case. Neither the intervenors nor Staff advanced proposals to modify the FAC baseline asserts IEU-Ohio.

IEU-Ohio next disputes the Companies' argument that the intervenors are claiming a property ownership interest in the coal reserve for ratepayers. IEU-Ohio asserts that nowhere did the intervenors or Staff claim such an ownership interest but simply that the benefits that have been deprived of OP customers be netted against the costs that OP has billed and collected from customers. Next, IEU-Ohio maintains that it is not challenging the appropriateness of the accounting based on any conflict with GAAP, but rather makes a ratemaking recommendation for the Commission's consideration. Lastly, IEU-Ohio avers that, contrary to the Companies position, IEU-Ohio did consider the production bonus payment made in 2008 and agreed that the FAC customers had paid their fair share of the costs of that contract (Tr. II at 255). For these reasons, IEU-Ohio urges the Commission to adopt its recommendations to more fairly balance the benefits and the costs associated with the coal supply contracts discussed in this proceeding.

3. OCC's Position

OCC submits that AEP-Ohio is attempting to pass on to its customers all of the Companies costs under certain fuel procurement contracts, while keeping the majority of the benefits acquired in the contracts, thereby causing its customers to pay more fuel cost than authorized by law in violation of Section 4928.143(B)(2)(a), Revised Code, and Rule 4901:1-35-03(C)(9)(a)(ii), O.A.C. For example, similar to the position taken by IEU-Ohio, OCC asserts that the Companies 2008 Settlement Agreement produced added costs for customers while AEP-Ohio only shared a portion of the lump sum payments the Companies received as well as only a portion of the West Virginia coal reserve. Another example of AEP-Ohio passing along increased costs while keeping the majority of the benefits is the renegotiated coal procurement contract whereby AEP-Ohio agreed to pay the coal provider an increased price of coal per ton during 2009 while having the opportunity to receive a per ton discount on all tons of coal delivered from 2013-2018.

To prevent AEP-Ohio from recovering more fuel cost from its customers than the Companies should under law, OCC submits that the Commission should order that AEP-Ohio's customers receive the financial benefits from the Companies fuel procurement contracts through immediate credits to AEP-Ohio's FAC deferral balance. As previously discussed, those fuel procurement benefits that should be credited against the FAC deferral balance include the full lump sum payment and the fair value of the West Virginia coal reserve that was part of the settlement agreement as well as the fair value of the coal market price discount option for future coal delivery negotiated as part of the 2008 Contract Support Agreement. Any delay in applying these credits will unnecessarily increase the burden to the customers of OP because the carrying charges associated with OP's fuel cost deferral can exceed $10 million every three months (OCC Ex. 1 at 16).

Responding to the Companies' arguments, OCC asserts that the underlying ESP decision and the January 7, 2010, entry in this case do not limit the Commission's review of AEP-Ohio's fuel procurement contracts to only those entered into during the 2009 FAC period. Additionally, OCC argues that neither OCC nor IEU-Ohio are attempting to "claw back" revenue from a prior rate plan as argued by AEP-Ohio. Moreover, the FAC baseline is not relevant, claims OCC, to the issue of requiring AEP-Ohio to recover only its actual fuel cost nor does the FAC baseline constitute res judicata. OCC's final argument is that requiring AEP-Ohio to recover only its actual fuel cost does not constitute selective or retroactive ratemaking as argued by the Companies.

4. Staff's Position

As a general matter, Staff supports the findings and recommendations contained in the Audit Report and recommends that those recommendations be adopted by the Commission. Staff acknowledges that the Companies are entitled to recover the costs of fuel but only to recover the true cost incurred. In other words, Staff asserts that any proceeds received offsetting the cost of fuel should be credited against under-recoveries, regardless of the period in which the proceeds are recognized. Since the value of such credits cannot be determined at this time, Staff recommends that the Commission direct the auditor to evaluate the value of proceeds received by the Companies and not credited either to the FAC or to deferred under-recoveries and make recommendations in the next audit proceeding as to the value to be credited.

Responding to a number of AEP-Ohio arguments, Staff notes that arguments concerning prohibited retroactive ratemaking and imprudence are irrelevant and have not been raised by the auditor's report. AEP-Ohio's arguments concerning regulatory accounting are rejected by Staff as the Commission and not the Companies determine the appropriate accounting for regulatory purposes. Staff does agree with the Companies that Ohio ratepayers do not own the coal reserves that were part of the Settlement Agreement, however, Staff asserts that the value of the coal reserves is part of the cost of fuel and therefore should be examined by the next auditor.

D. Commission Conclusion on Management Audit Recommendations

Initially, the Commission notes that there were very few concerns raised by the parties as to the auditor's m/p recommendations 2 through 6 found at pages 1-7 of the audit. Therefore, the Commission will adopt the auditor's m/p recommendations 2 through 6 as outlined in the audit. The Commission notes that there were, however, widely contrasting positions taken by the parties concerning m/p audit recommendation 1 which recommends that the Commission should review whether any proceeds from the Settlement Agreement (i.e., the 2008 lump sum payment AEP-Ohio received as well as the West Virginia coal reserve) should be a credit against OP's FAC under-recovery.

Following a thorough review of the record and the arguments raised by the parties in this matter, the Commission determines that all of the realized value from the Settlement Agreement should be credited against OP's FAC under-recovery namely the portion of the $30 million 2008 lump sum payment not already credited to OP ratepayers as well as the $41 million value of the West Virginia coal reserve that AEP booked when the Settlement Agreement was executed. Additionally, because the value of the West Virginia coal reserve is not clear and because AEP had planned to begin the permitting process at the time of the audit which should enhance the value of the coal reserve, we direct AEP to hire an auditor specifically to examine the value of the West Virginia coal reserve and to make a recommendation to the Commission as to whether the increased value, if any above the $41 million already required to be credited against OP's under-recovery, should accrue to OP ratepayers beyond the value of the reserve that AEPSC booked under the Settlement Agreement. The Commission will issue by subsequent entry a Request for Proposal to hire the auditor discussed above.

In making the above determination the Commission notes that the record reflects that the Settlement Agreement was entered into in order to terminate a long-term coal supply agreement, entered into in 1992, because the price of coal under the agreement was significantly below market in mid-2007. This long-term agreement was replaced with a new agreement which resulted in OP ratepayers paying significantly more for coal beginning in 2009, the start of the ESP period, than would have been paid had the Settlement Agreement not been entered into. We recognize that this situation is somewhat unique given that OP's fuel costs were not regulated during the period when the buyout occurred and the benefits booked yet the value was realized from coal that should have been delivered during the ESP period. While we do not find any motivation by AEPSC to transfer value from ratepayers during the ESP to an earlier date, nevertheless, the long-term coal agreement was an OP asset for which the value would have flowed through to OP ratepayers through the ESP period but for the extraordinary circumstances related to the early contract termination. Given these factors, we agree with Staff that, in order to determine the real economic cost of coal used during the audit period, more of the value realized by AEP for entering into the Settlement Agreement should flow through to OP ratepayers through a credit to OP's under-recovery and deferrals.

Citing to the ESP cases (Case Nos. 08-917-EL-SSO and 08-918-EL-SSO, Opinion and Order, March 18, 2009, at pages 14-15) and an earlier entry in this proceeding, AEP-Ohio argues that the Commission limited the audit period and the prudence review in this case to 2009 procurement activities and that the only relevant factor is the price the Companies paid for coal during 2009. The Commission disagrees. Contrary to the Companies argument, the Commission is not seeking to reach into another audit period in order to modify rates charged during the audit period but rather is rendering its decision in order to match the revenues and benefits incurred during the audit period. Nor has the Commission found that entering into the Settlement Agreement was imprudent. Again, the Commission is only finding that to determine the real economic cost of coal during the audit period, the Commission must consider both the revenues and the benefits received by the Companies pursuant to the Settlement Agreement and not rely solely on the price paid for coal during 2009. AEP-Ohio further claims that the parties in this case are attempting to illegally relitigate the FAC baseline established in the ESP cases. AEP-Ohio's claims are without merit as the Commission has not adjusted the baseline for the 2009 period as decided in the Companies ESP cases. Rather, the Commission, in this case, is engaging in a reconciliation and accounting which was explicitly contemplated by the ESP cases in future FAC proceedings. Otherwise, there would be no rationale for undertaking an annual audit. In this case, the Commission is making an accounting adjustment to recognize extraordinary events affecting 2009 costs such that the Companies 2009 real costs will be comparable to the proxy baseline selected in the ESP proceedings.

AEP-Ohio's arguments concerning the applicability of *Keco* and *Lucas Cty.* are likewise unavailing. According to the Companies, any attempt to credit amounts booked in 2008 during the prior rate plan would violate the longstanding prohibition against retroactive ratemaking established in *Keco.* However, *Keco* does not apply in this situation. The Commission is not considering modifying a previous rate established by a Commission order through the ratemaking process as the Court considered in *Keco.* Rather, the Commission, by ordering the Companies to credit more of the proceeds from the Settlement Agreement to OP's deferral balance, is establishing a future rate based upon the real cost of the coal used by the Companies to generate electricity during the 2009 FAC audit period. The proceeds AEP-Ohio received for entering into the Settlement Agreement are but one of the components which impact the Companies cost to provision electricity during 2009. Likewise, *Lucas Cty.* does not apply to the present situation. In *Lucas Cty.*, the Court held that the Commission was not statutorily authorized to order a refund of, or credit for, charges previously collected by a public utility where those charges were calculated in accordance with an experimental rate program which has expired. As noted above, the Commission has not made a determination modifying the rate the Companies collected during 2009. Additionally, there is no experimental rate program involved in the current case. Thus, *Lucas Cty.* does not apply in this matter.

As to any benefits associated with the delivery shortfall agreement and the contract support agreement that OCC and IEU-Ohio assert should also be factored into the Companies FAC under-recovery, the Commission determines that any effect these agreements may have had on AEP-Ohio's fuel costs, if any, would appear to apply in time periods outside of the current audit. Therefore, while those agreements may be examined by a future audit, those agreements will not be further examined as part of the current audit.

IV. Financial Audit Recommendations

The audit report also included six financial audit recommendations. In the first recommendation, the auditors submit that the FAC workbooks should be modified to include explanations that identify and/or explain differences between includable FAC amounts recorded in the general ledger versus includable FAC amounts derived from other sources (e.g., Monthly Purchase Summary Reports). Additionally, these explanations should also apply to issues such as timing differences and/or prior period adjustments. The second recommendation is that CSP and OP should include the reconciliation of the fuel and purchased power accounts that have been designated as includable FAC costs with the monthly FAC workbooks, to facilitate a clear audit trail. The third financial audit recommendation is that the Companies overall should provide a better audit trail for tracing costs. Fourth, the auditors suggest that the Commission may want to have AEP-Ohio explain further how the four generating units designated as "must run" units by PJM are affecting the costs that are recoverable in the FAC. The fifth financial audit recommendation is that the Companies should update and/or modify its systems in order to better indicate hourly or 24-hour dispatch costs and off-system sales cost information related to forced outages.

AEP-Ohio witness Dooley testified that the Companies agree with and plan to implement the auditors recommendations regarding financial audit items 1, 2, and 3 (Co. Ex. 1 at 6). The Companies' witnesses did not specifically address financial audit recommendations 4 and 5. The Companies otherwise did acknowledge, however, that AEP-Ohio agreed with and planned to implement the financial audit recommendations as clarified in the Companies' testimony (Cos. Brief at 51).

As AEP-Ohio does not challenge financial audit recommendations 1 through 5, the Commission will adopt such recommendations made in the audit report.

The final financial audit recommendation involves the River Transportation Division (RTD) and has 10 sub-components. The audit report suggests that RTD should respond to the following prior to the next audit and that the next auditor should review the results of this additional information:

(a) RTD should be required to explain and justify the rationale of the Net Investment Base and Cost of Capital Billing Adder formula presented in EVA 4-5, Confidential Attachments 1 and 2.

(b) RTD should be required to provide a procedure for updating the cost of capital and the Return on Equity (ROE) component that is commensurate with the risk of the operation.

(c) An Over Collection by RTD indicates that RTD collected too much from the affiliated companies for barge operations in a particular year. The Over Collection should be a subtraction from the Investment Base (rather than an addition to RTD's expenses).

(d) RTD should provide documentation that it corrected its calculation of the 2008 Working Capital Requirement and the 2009 Working Capital Requirement and the resulting credits $43,314 (2008) and $45,117 (2009) to RTD's customers were recorded in its 2nd Quarter's 2010 true up and credited to the operating companies in August 2010. OP's portion of these credits is $15, 298 (2008) and $17,325 (2009).

(e) Balance Sheet items such as Prepayments, Materials and Supplies inventory and Other Current and Accrued Liabilities, if considered in developing a utility's rate base, are typically added or subtracted on a 13-month average balance basis. RTD should be required to explain why its current methodology of dividing balance sheet items (such as prepayments, materials and supplies inventory, and other current and accrued liabilities) by eight to derive the Investment Base is a reasonable and appropriate method.

(f) OP, RTD and other AEP affiliates that utilize the RTD should work together to revise the RTD formula to conform with generally accepted public utility industry rate base and ratemaking standards. OP should report quarterly concerning the progress of these efforts by including a description of progress made in its quarterly FAC filings.

(g) The details of RTD charges including, but not limited to, Other Administration Expenses and "AEP Admin Charges" such as those provided by AEP in response to LA 7-17, should be reviewed in detail in the next audit period.

(h) RTD should prepare a justification for how RTD's income tax expense and Accumulated Deferred Income Taxes are handled.

(i) RTD should explain the Accumulated Deferred Income Taxes (ADIT) amounts on its Balance Sheet and identify any amounts and components related to the use of accelerated tax depreciation.

(j) To the extent that RTD has cost-free capital in the form of ADIT related to the use of accelerated tax depreciation (which would typically be associated with credit-balance ADIT amounts), RTD should prepare an explanation why that cost-free capital should not be subtracted in deriving the Investment Base, similar to how ADIT balances would be subtracted in deriving a utility's rate base.

Regarding financial audit recommendations 6a, 6e, 6f, and 6j, the Companies state that, although the current treatment is a reasonable approach, AEP-Ohio is willing to have the RTD division amend its calculation to be in accordance with the traditional base treatment recommended by the audit report starting January 1, 2011 (Co. Ex. 3 at 11). Financial audit recommendation 6b is unnecessary, says AEP-Ohio, because there is already a procedure in place for updating the cost of capital and Return on Equity component commensurate with the risk (*Id.*). AEP-Ohio witness Nelson testified that the ROE is adjusted on January 1 each year to the return allowed by FERC. In the absence of a recent FERC order, the ROE becomes that established by the Indiana Utility Regulatory Commission in its most recent order (*Id.* at 11-12). Regarding financial audit recommendations 6c and 6d, the Companies explain that RTD has made all necessary changes to correct the Working Capital Requirement for 2008 and 2009 and will appropriately credit the applicable operating companies including OP. Documentation will be available for the next audit states AEP-Ohio (Co. Ex. 1 at 6). Similarly, the Companies have no objections to financial audit recommendations 6g, 6h, and 6i. AEP-

Ohio commits that the necessary explanations will be available for the next audit (Co. Ex. 1 at 6-7; Co. Ex. 3 at 12).

Generally, the Companies agree with and plan to implement financial audit recommendations 6a through 6i. Regarding financial audit recommendation 6b, the Companies have adequately explained and thus have complied with the auditors' recommendation. Therefore, no further action is required by the Companies on financial audit recommendation 6b. The Commission adopts as its determinations in this matter, financial audit recommendations 6a through 6i with the exclusion of recommendation 6b discussed in the preceding sentence.

V. Ormet stipulation

Rule 4901-1-30, Ohio Administrative Code, authorizes parties to Commission proceedings to enter into a stipulation. Although not binding on the Commission, the terms of such an agreement are accorded substantial weight. *Consumers' Counsel v. Pub. Util. Comm.* (1992), 64 Ohio St.3d 123, 125, *citing Akron v. Pub. Util. Comm.* (1978), 55 Ohio St.2d 155. This concept is particularly valid where the stipulation is unopposed by any party and resolves all issues presented in the proceeding in which it is offered.

The standard of review for considering the reasonableness of a stipulation has been discussed in a number of prior Commission proceedings. *Cincinnati Gas & Electric Co.*, Case No. 91-410-EL-AIR (April 14, 1994); *Western Reserve Telephone Co.*, Case No. 93-230-TP-ALT (March 30, 1994); *Ohio Edison Co.*, Case No. 91-698-EL-FOR *et al.* (December 30, 1993); *Cleveland Electric Illum. Co.*, Case No. 88-170-EL-AIR (January 30, 1989); *Restatement of Accounts and Records (Zimmer Plant)*, Case No. 84-1187-EL-UNC (November 26, 1985). The ultimate issue for our consideration is whether the agreement, which embodies considerable time and effort by the signatory parties, is reasonable and should be adopted. In considering the reasonableness of a stipulation, the Commission has used the following criteria:

(1) Is the settlement a product of serious bargaining among capable, knowledgeable parties?

(2) Does the settlement, as a package, benefit ratepayers and the public interest?

(3) Does the settlement package violate any important regulatory principle or practice?

The Ohio Supreme Court has endorsed the Commission's analysis using these criteria to resolve issues in a manner economical to ratepayers and public utilities. *Indus. Energy Consumers of Ohio Power Co. v. Pub. Util. Comm.* (1994), 68 Ohio St.3d 559, *citing*

Consumers' Counsel, supra, at 126. The court stated in that case that the Commission may place substantial weight on the terms of a stipulation, even though the stipulation does not bind the Commission (*Id.*).

We find that the Ormet stipulation entered into by the stipulating parties is reasonable and should be adopted. In making this determination, the Commission notes that the Ormet stipulation is a product of serious bargaining among capable, knowledgeable parties and is the product of an open process. Moreover, as a package, the Ormet stipulation benefits ratepayers and furthers the public interest as a more thorough examination involving the collection of deferrals and carrying charges associated with the provision of service to Ormet is already the subject of a pending case before the Commission in *In the Matter of the Application of Columbus Southern Power and the Ohio Power Company to Recover Commission-Authorized Deferrals Through each Company's Fuel Adjustment Clause,* Case No. 09-1094-EL-FAC (09-1094). Therefore, a detailed examination of the complex issues surrounding AEP-Ohio's provision of service to Ormet, the largest, most energy-intensive customer that the Companies serve in Ohio, does not have to be considered in this proceeding. Finally, the Commission finds that there is no evidence that the stipulation violates any important regulatory principle or practice and, therefore, the stipulation meets the third criterion. Accordingly, the Ormet stipulation is approved.

FINDINGS OF FACT AND CONCLUSIONS OF LAW:

(1) CSP and OP are public utilities under Section 4905.02, Revised Code, and are subject to the jurisdiction of this Commission.

(2) These cases relate to the Commission's review of CSP and OP's fuel costs during the period from January 1, 2009, through December 31, 2009.

(3) By entry issued January 7, 2010, the Commission selected EVA to perform CSP and OP's audit for the period of January 1, 2009, through December 31, 2009. On May 14, 2010, EVA filed its audit report.

(4) On January 7, 2010, IEU-Ohio, OCC, and Ormet were granted intervention in these cases.

(5) A hearing in these matters was held on August 23 and August 24, 2010.

(6) Briefs and reply were filed on September 23, 2010, and October 15, 2010, respectively.

(7) At the hearing, a stipulation was submitted acknowledging that a determination on the collection of deferrals and carrying charges associated with an Ormet Interim Agreement is the subject of a pending case before the Commission and that the issues associated with the Ormet Interim Agreement would be addressed in that proceeding. The stipulation was signed by AEP-Ohio, Staff, OCC, IEU-Ohio, and Ormet. The stipulation meets the criteria used by the Commission to evaluate stipulations, is reasonable, and should be adopted.

ORDER:

It is, therefore,

ORDERED, That the Companies credit OP's FAC under-recovery as discussed herein. It is, further,

ORDERED, That the Companies hire an auditor as discussed herein. It is, further,

ORDERED, That the stipulation entered into by AEP-Ohio, Staff, OCC, IEU-Ohio, and Ormet be adopted and approved. It is, further,

ORDERED, That AEP-Ohio take all necessary steps to carry out the terms of this opinion and order. It is, further,

ORDERED, That nothing in this opinion and order shall be binding upon the Commission in any future proceeding or investigation involving the justness or reasonableness of any rate, charge, rule, or regulation. It is, further, ORDERED, That a copy of this opinion and order be served upon each party of record.

THE PUBLIC UTILITIES COMMISSION OF OHIO

Todd A. Snitchler, Chairman

Paul A. Centolella

Steven D. Lesser

Andre T. Porter

Cheryl L. Roberto

JRJ/vrm

Entered in the Journal

JAN 23 2012

Betty McCauley

Betty McCauley
Secretary