

**BEFORE THE  
THE PUBLIC UTILITIES COMMISSION OF OHIO**

In the Matter of the Commission Review of	)	
the Capacity Charges of Ohio Power	)	Case No. 10-2929-EL-UNC
Company and Columbus Southern Power	)	
Company.	)	

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**POST-HEARING BRIEF OF FIRSTENERGY SOLUTIONS CORP.**

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## I. INTRODUCTION

This case involves Ohio Power Company's ("AEP Ohio") request to change the only method that has ever been in place for capacity pricing and to replace it with over a billion dollars in above-market capacity prices for the period in question.<sup>1</sup> As has been recognized by every intervenor witness and Staff, market-based pricing, as established through the PJM Interconnection LLC's ("PJM") Reliability Pricing Model ("RPM"), is the correct pricing mechanism for capacity in both the short run and the long run. Ohio law and policy require a competitive market for electric generation service. Market-based pricing protects customers from improper charges from a monopoly provider, encourages accurate price signals for Ohio's competitive market, and avoids eliminating Ohio customers' ability to seek savings from competitive retail electric service ("CRES") providers. The Federal Energy Regulatory Commission ("FERC") has declared that RPM prices are "just and reasonable."<sup>2</sup> And, RPM prices have been used to set the price for capacity in Ohio's competitive market for years. Customers in every other EDU's territory in the state, including other FRR entities, provide capacity at RPM, market-based rates. Their capacity is no different than the capacity that AEP Ohio must provide to all of its customers.

AEP Ohio is now asking the Commission to ignore state law and policy, the numerous well-established benefits of market-based pricing and also prior Commission orders prohibiting the recovery of stranded costs in requesting guaranteed, "full embedded cost-based" pricing. The question that has remained unanswered to date is simple: why should Ohio change its

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<sup>1</sup> FES Ex. 103, Direct Testimony of Jonathan A. Lesser ("Lesser Direct"), p. 3.

<sup>2</sup> See FES Ex. 118, PJM Interconnection Docket Numbers ER05-1410-05 and EL05-14805, FERC Order dated November 15, 2007.

capacity pricing mechanism and give AEP Ohio above-market prices for capacity? After weeks of testimony there is still no answer to this simple question. AEP Ohio alleges that it will suffer financial harm if it provides capacity at the RPM-based prices it has charged for years. This argument clearly fails because AEP Ohio lobbied for the Fixed Resource Requirement (“FRR”) alternative and voluntarily made this election for each year knowing that it would receive RPM pricing, so there is no surprise to AEP Ohio in how it would be compensated. Despite the unsubstantiated rhetoric, AEP Ohio has presented no probative evidence to establish that it requires this pricing to avoid “imminent financial harm.” Instead, it has only presented a misleading analysis comparing RPM pricing to a two-tiered capacity pricing structure that is not before the Commission in this case. AEP Ohio also asserts that it needs cost-based prices to allow for investments in generation resources. However, AEP Ohio’s own expert witnesses acknowledge that PJM’s RPM market is working well and has incentivized the appropriate amount of new generation. Thus, the cost-based prices proposed by AEP Ohio will simply lead to illegal and improper cross-subsidies in favor of AEP Ohio. Every other provider within PJM receives market pricing for capacity, so requiring AEP Ohio to charge market pricing for capacity would ensure it is treated the same as every other provider in PJM for providing the same product. In short, AEP Ohio has failed to provide any reason why the Commission should adopt a new state compensation mechanism.

Rather than justifying its proposed capacity rate as just and reasonable, AEP Ohio has testified that it considers its proposed formula capacity charge to be an “exit fee” for leaving the “regulated environment.” AEP Ohio classified this “exit fee” as “the charge that we were going to make to the outside providers for customers exiting our regulated environment.”<sup>3</sup> This

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<sup>3</sup> Hearing Transcript (“Tr.”) Vol. II, p. 410.

statement demonstrates that AEP Ohio considers this capacity pricing formula to be yet another means to stop competition and extract an additional charge from shopping customers for the “privilege” of shopping under Ohio law. This is not a valid basis for establishing a new state compensation mechanism for capacity. Instead, it is an effort to game the system by seeking the higher of cost or market while RPM costs are low.

AEP Ohio has failed to provide any valid reason to radically alter the capacity pricing structure that has been consistently used by every PJM market participant in Ohio, including AEP Ohio. Instead, AEP Ohio’s proposed structure is nothing more than a desperate, last-ditch effort to stop shopping by seeking a windfall from Ohio customers. AEP Ohio’s proposal should be rejected by the Commission.

## **II. FACTUAL BACKGROUND**

### **A. AEP Ohio Voluntarily Made The FRR Election While Ohio Maintained A Competitive Market For Electric Generation Service.**

PJM, as the Regional Transmission Organization (“RTO”), is responsible for the bulk power system for a large portion of the U.S., including Ohio.<sup>4</sup> In that role, PJM operates a financial market for the purchase and sale of energy and capacity in its region.<sup>5</sup> That financial market is established through PJM’s RPM, which uses the Base Residual Auction (“BRA”) process to establish capacity prices three years in advance.<sup>6</sup> Bidders whose resources clear the auction are paid the RPM price for providing capacity in the relevant planning year. The final RPM price (or, as used herein, RPM pricing) for any given planning year reflects the BRA results, combined with any other incremental auctions. PJM designed the RPM to provide

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<sup>4</sup> FES Ex. 101, Direct Testimony of Robert B. Stoddard, filed Apr. 4, 2012 (“Stoddard Direct”), p. 6.

<sup>5</sup> Stoddard Direct, p. 6.

<sup>6</sup> Tr. Vol. II, p. 388; Stoddard Direct, pp. 7-8 (Load prices are also modified by three incremental auctions prior to the delivery year. These auctions do not significantly change the BRA results.)

appropriate economic signals to capacity suppliers to make available sufficient resources to meet the forecast reliability requirements.<sup>7</sup>

Seven years after the General Assembly established a competitive market for electric generation service in Ohio, AEP Ohio and the other AEP East operating companies “advocated strongly at FERC and during the [PJM] stakeholder negotiations” for an alternative to the BRA for qualifying load serving entities (“LSEs”) -- called the Fixed Resource Requirement (“FRR”) option.<sup>8</sup> Under the terms of PJM’s Reliability Assurance Agreement (“RAA”), an FRR entity must submit a plan to meet the resource needs of all load served through its distribution system.<sup>9</sup> As a result of this extensive lobbying and their own election, these AEP companies have by their own request been an FRR provider of capacity for all load in the AEP East zone since 2007.<sup>10</sup> The resources utilized to meet this requirement are not restricted to AEP East units; AEP can contract with other generators and submit those resources as part of their FRR plan. The AEP East companies, thus, chose to be responsible for supplying sufficient resources to meet the load in their transmission zone.<sup>11</sup> All CRES providers serving customers in AEP Ohio’s service territory must pay AEP Ohio for the capacity provided to their customers.<sup>12</sup>

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<sup>7</sup> Stoddard Direct, pp. 6-7.

<sup>8</sup> AEP Ohio Ex. 103, Direct Testimony of Dana E. Horton, filed March 23, 2012 (“Horton Direct”), p. 5.

<sup>9</sup> Stoddard Direct, p. 9.

<sup>10</sup> Tr. Vol. II, p. 395; Horton Direct, p. 2. The FRR Plan for the 2012/2013 Planning Year was filed in the spring of 2009; for the 2013/2014 Planning Year was filed in the spring of 2010; and for the 2014/2015 Planning Year was filed in the spring of 2011.

<sup>11</sup> Stoddard Direct, p. 9.

<sup>12</sup> AEP Ohio will not allow CRES providers to provide their own capacity until after AEP Ohio’s current FRR plan ends. Tr. Vol. II, p. 232. LSEs such as FES are therefore “locked in” through the 2014/15 Planning Year. Stoddard Direct, p. 10. Thus, the earliest period an LSE could elect to self supply is for the 2015/16 Planning Year. This option is moot, however, because AEP Ohio has participated in the RPM auction for the 2015/2016 Planning Year and beyond. Stoddard Direct, p. 10.



The sole reason that the AEP East companies made the FRR election was because AEP believed the FRR election would be better for them than participating in the BRA.<sup>13</sup> The AEP East companies could avoid paying auction rates for capacity and avoid the risk of units not clearing the BRA. AEP Ohio -- operating under Ohio's competitive market unlike its other AEP East affiliates<sup>14</sup> -- could have elected to participate in the RPM even though the rest of the AEP entities made an FRR election. But, AEP Ohio chose not to do so.<sup>15</sup> AEP Ohio, thus, made the election to become an FRR Entity with full knowledge that the AEP East pool would have the responsibility of including all of AEP Ohio's retail load, both SSO load and shopping load, in its FRR Capacity Plan. AEP Ohio made this election despite being subject to competition for generation service in its service territory.<sup>16</sup>

**B. After Consistently Charging RPM Market-Based Prices For Capacity, AEP Ohio Now Seeks To Charge Its "Full Embedded Costs" That Are Four Times Higher Than Market.**

From its FRR election in 2007 through 2011, AEP Ohio charged CRES providers the RPM, market-based prices for capacity.<sup>17</sup> Indeed, prior to the implementation of (now interim) two-tiered capacity pricing under the Partial Stipulation beginning in January 2012, the only price for capacity that AEP Ohio has ever charged is the RPM market-based price. In fact, AEP Ohio acknowledged that RPM market-based pricing for capacity was appropriate in its 2008 ESP proceedings.<sup>18</sup>

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<sup>13</sup> Tr. Vol. II, p. 396.

<sup>14</sup> Tr. Vol. II, p. 397-398.

<sup>15</sup> Tr. Vol. II, p. 476; Stoddard Direct, p. 9.

<sup>16</sup> Stoddard Direct, p. 9.

<sup>17</sup> AEP Ohio Ex. 101, Direct Testimony of Richard Munczinski, filed March 23, 2012 ("Munczinski Direct"), pp. 5-6.

<sup>18</sup> Stoddard Direct, p. 43 (citing Direct Testimony of Craig Baker on Behalf of CSP and OPCo, Case No. 08-918-EL-SSO, at 11, lines 11-14, ("PJM Capacity Obligations - This component reflects the cost of

Then, on November 24, 2010, in FERC Case No. ER11-2183-000, AEP Ohio sought to alter the basis by which it is compensated for capacity provided for shopping customers.<sup>19</sup> In that proceeding, AEP Ohio proposed that the same cost-based capacity charges it later proposed in this docket would be charged to CRES providers for load that migrated from AEP Ohio to CRES providers.<sup>20</sup> AEP Ohio's proposed combined rate was \$388/MW-day using 2009 data.<sup>21</sup> AEP Ohio did not notify CRES providers ahead of time that it intended to seek this dramatically higher rate, which advance notice would have enabled CRES providers to elect their own capacity into AEP Ohio's FRR plan and thereby avoid this rate.<sup>22</sup> Moreover, AEP Ohio testified that it considered its proposed "cost based" capacity charge to be an "exit fee" on Ohio customers.<sup>23</sup> AEP Ohio witness Horton, AEP Ohio's primary PJM witness, testified to the purpose of the capacity charge "exit fee" proposed by AEP Ohio in this case: "In my mind that was the charge that we were going to make to the outside providers for customers exiting our regulated environment."<sup>24</sup>

In response to this application, on December 8, 2010, the Commission re-affirmed RPM pricing as Ohio's interim state compensation mechanism for capacity.<sup>25</sup> RPM pricing remained in effect until the Commission adopted, on December 14, 2011, with certain modifications, the

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PJM's required capacity obligations for load serving entities and was derived from the PJM Reliability Pricing Model (PJM Capacity Auction) results for the relevant time period." (Emphasis added.)).

<sup>19</sup> December 8, 2010 Opinion and Order, ¶ 3.

<sup>20</sup> FERC Case No. ER11-2183-000.

<sup>21</sup> FERC Case No. ER11-2183-000.

<sup>22</sup> Tr. Vol. II, pp. 233-36, 405-08.

<sup>23</sup> Tr. Vol. II, pp. 408-410.

<sup>24</sup> Tr. Vol. II, p. 410.

<sup>25</sup> December 8, 2010 Opinion and Order, ¶ 5.

two-tiered capacity pricing contained in the Partial Stipulation.<sup>26</sup> The Commission later reversed this decision, finding that the Partial Stipulation was not more favorable than a market-rate offer and was not in the public interest, necessitating this proceeding.<sup>27</sup>

While AEP Ohio has attempted to frame this case as CRES providers seeking to use AEP Ohio's capacity at an improper rate, the facts clearly establish that it is AEP Ohio that has sought to change the rules. AEP Ohio advocated for the FRR option, not CRES providers. AEP Ohio made the FRR election each year, not CRES providers. AEP Ohio priced its capacity at RPM from 2007 to 2011, not CRES providers. AEP Ohio cited RPM prices as the appropriate method to price capacity in its 2008 ESP proceedings, not CRES providers. AEP Ohio failed to give adequate notice to CRES providers of its plan to quadruple capacity pricing, in what is a classic bait-and-switch. And, it is AEP Ohio that now seeks to change the capacity pricing structure to charge the higher of cost or market during a period when CRES providers are captive to AEP Ohio's exercise of market power.

Indeed, AEP Ohio's proposed capacity pricing would impose a massive price increase on shopping customers. AEP Ohio is proposing a capacity price of \$355.72/MW-day.<sup>28</sup> The RPM clearing prices for the relevant period are much lower: \$16.52/MW-day (12/13); \$27.73/MW-day (13/14); and \$125.94/MW-day (14/15).<sup>29</sup> The "as billed" RPM prices charged to CRES providers, which include adjustments for losses and scalars, will be slightly higher: \$19.89/MW-day (12/13); \$33.87/MW-day; and \$153.99/MW-day.<sup>30</sup> The weighted average load price is

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<sup>26</sup> December 14, 2011, Opinion and Order, pp. 54-55.

<sup>27</sup> February 23, 2012, Opinion and Order, pp. 12-13.

<sup>28</sup> AEP Ohio Ex. 102, Direct Testimony of Kelly D. Pearce, filed March 23, 2012 ("Pearce Direct"), p. 21.

<sup>29</sup> Stoddard Direct, p. 25.

<sup>30</sup> Stoddard Direct, p. 25; Lesser Direct, p. 35.

\$78.55/MW-day, as compared to AEP Ohio's proposed \$355.72/MW-day.<sup>31</sup> Thus, AEP Ohio's proposed capacity price obviously will have an impact on the competitive market because it will increase *by four times* a significant cost component to the provision of retail electric generation service.<sup>32</sup>

**C. The FERC Has Found RPM Prices To Be “Just And Reasonable” And Has Questioned AEP Ohio's Cost-Based Rate.**

The FERC has determined that RPM prices are “just and reasonable because mitigation measures will constrain sellers to submit bids that prevent the exercise of market power, with the result that prices will approximate those of a competitive market.”<sup>33</sup> The FERC noted that:

**Such competitive market mechanisms provide important economic advantages to electricity customers in comparison with cost of service regulation.** For example, a competitive market with a single, market-clearing price **creates incentives for sellers to minimize their costs**, because cost-reductions increase a seller's profits. And when many sellers work to minimize their costs, **competition among them keeps prices as low as possible.**<sup>34</sup>

Based on the FERC's strong support of the RPM model to provide a just and reasonable rate that takes advantages of the benefits of competition, it is not surprising that the FERC recently questioned AEP's request for a “cost-based” capacity pricing formula to be paid by competitive suppliers in Michigan. AEP's request, filed by AEP Ohio's affiliate AEP Indiana Michigan (“I&M”), was based on the same inappropriate formula rates offered here by AEP Ohio. On April 30, 2012, FERC held that AEP I&M's proposed “cost-based” capacity pricing structure did not pass the smell test:

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<sup>31</sup> Stoddard Direct, p. 25.

<sup>32</sup> See Section C.2(a), *infra*.

<sup>33</sup> FES Ex. 118 (121 FERC ¶ 61,173, FERC Docket No. ER05-1410-005 and EL05-148-005, Order Denying Rehearing, Nov. 15, 2007) at ¶ 24.

<sup>34</sup> *Id.* at ¶ 32 *quoting* 117 FERC ¶ 61,331, Dec. 22 Order, at ¶ 141 (emphasis added).

Preliminary analysis indicates that I&M's filing has not been shown to be just and reasonable and **may be unjust, unreasonable, unduly discriminatory or preferential, or otherwise unlawful**. In *West Texas*, the Commission explained that when the Commission's preliminary analysis indicates that the proposed rates may be unjust and unreasonable, and may be substantially excessive, as defined in *West Texas*, the Commission will generally impose a five-month suspension. **The Commission's preliminary analysis in this proceeding indicates that the proposed rate may be substantially excessive.**<sup>35</sup>

Based on its finding that AEP I&M's cost-based capacity proposal may be "unjust, unreasonable, unduly discriminatory or preferential, or otherwise unlawful," the FERC imposed the maximum five-month suspension of AEP's request.<sup>36</sup> AEP Ohio's mirror-image request here should be rejected.

### III. ARGUMENT

#### A. RPM Market-Based Pricing Is The Proper Compensation Mechanism For Capacity in Ohio, Including AEP Ohio's Service Territory.

The prices resulting from PJM's RPM process, which the FERC has declared as "just and reasonable," are well-supported. Indeed, the support for RPM capacity prices -- and the arguments against AEP Ohio's proposed cost-based pricing -- is also found in the terms of PJM's RAA, Ohio law and policy, and basic economic principles.

##### 1. Ohio law and policy calls for a market-based state compensation mechanism.

The RAA establishes specific parameters for FRR entities' prices for capacity provided to retail suppliers, which should lead the Commission to establish RPM-based prices as the price for capacity provided by AEP Ohio. Schedule 8.1, Section D.8 of the RAA provides:

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<sup>35</sup> FERC Docket No. ER12-1173-000, Order Accepting Formula Rate Proposal And Establishing Hearing And Settlement Judge Procedures, Apr. 30, 2012, at ¶ 21 (internal citations to *West Texas* omitted) (emphasis added).

<sup>36</sup> *Id.*

In the case of load reflected in the FRR Capacity Plan that switches to an alternative retail LSE, where the state regulatory jurisdiction requires switching customers or the LSE to compensate the FRR Entity for its FRR capacity obligations, such state compensation mechanism will prevail. In the absence of a state compensation mechanism, the applicable alternative retail LSE shall compensate the FRR Entity at [rest-of-pool or “RTO” clearing prices], provided that the FRR Entity may, at any time, make a filing with FERC under Sections 205 of the Federal Power Act proposing to change the basis for compensation to a method based on the FRR Entity’s costs or such other basis shown to be just and reasonable.

Thus, the RAA establishes a clear sequence to determine the capacity rate that the FRR Entity may charge a CRES provider, with the “state compensation mechanism” taking precedence.<sup>37</sup>

Absent such a mechanism, the capacity rate is set at the RTO capacity clearing price in the RPM RTO.<sup>38</sup> The RAA’s reference to a state compensation mechanism does not refer to or mention the FRR entity’s costs.<sup>39</sup> The RAA provides an FRR Entity with the option to file a complaint at FERC to seek cost-based recovery, but based on the clear language of the RAA and the FERC’s ruling, this option for seeking a cost-based recovery mechanism is only available when there is no state compensation mechanism in place.<sup>40</sup> The state compensation mechanism applies when load switches to “an alternative retail LSE,” i.e., when customers are switching to CRES providers in a competitive market.

As applied to Ohio, the state compensation mechanism should be RPM, market-based pricing because Ohio law has established a competitive market for electric generation service.<sup>41</sup>

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<sup>37</sup> Stoddard Direct, p. 11.

<sup>38</sup> Stoddard Direct, p. 11.

<sup>39</sup> Tr. Vol. II, pp. 547-49; FES Ex. 110-C.

<sup>40</sup> See American Electric Power Serv. Corp., 134 FERC ¶ 61,039 (2011).

<sup>41</sup> See R.C. § 4928.03.

The General Assembly also adopted a number of state policies that the Commission is charged to enforce,<sup>42</sup> including the requirements to:

Ensure the availability of unbundled and comparable retail electric service that provides consumers with the supplier, price, terms, conditions, and quality options they elect to meet their respective needs; . . .

Ensure effective competition in the provision of retail electric service by avoiding anticompetitive subsidies flowing from a noncompetitive retail electric service to a competitive retail electric service or to a product or service other than retail electric service, and vice versa, including by prohibiting the recovery of any generation-related costs through distribution or transmission rates; . . . [and]

Ensure retail electric service consumers protection against unreasonable sales practices, market deficiencies, and market power . . . .<sup>43</sup>

As the FERC found, such a competitive market “provide[s] important economic advantages to electricity customers in comparison with cost of service regulation” and “keeps prices as low as possible.”<sup>44</sup> In order to carry out the state’s law and policy establishing Ohio’s competitive market and to foster that market, it follows that the state compensation mechanism should be based on market-based prices, not cost-based prices, for capacity -- and RPM prices are the best indicators of the market price for capacity.

Importantly, every one of the intervenor parties who presented testimony on this issue agreed that RPM prices should be used for the state compensation mechanism.<sup>45</sup> Though Staff did not offer testimony regarding the appropriate compensation mechanism during this hearing, Staff previously has filed testimony addressing this issue. Staff witness Choueiki testified that

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<sup>42</sup> R.C. § 4928.06.

<sup>43</sup> R.C. § 4928.02(B).

<sup>44</sup> FES Ex. 118 at ¶ 32 (*quoting* 117 FERC ¶ 61,331, Dec. 22 Order, at ¶ 141).

<sup>45</sup> *See, e.g.*, Exelon Ex. 101, Direct Testimony of David I. Fein, filed Apr. 4, 2012 (“Fein Direct”), p. 6; Schools Ex. 101, Direct Testimony of Mark Frye, filed Apr. 4, 2012 (“Frye Direct”), p. 11.

AEP Ohio's proposal to use cost-based rates was "not reasonable."<sup>46</sup> Staff also found that "to the extent there is a transparent forward capacity price available in the market, such a price should be used . . ."<sup>47</sup> Mr. Fortney agreed with this analysis, and agreed that Staff supported pricing at RPM.<sup>48</sup> Staff also has recently filed testimony regarding AEP Ohio's modified ESP proposal, and reiterated that AEP Ohio's proposed capacity pricing structure was "not reasonable."<sup>49</sup> Staff testified once again that it believed that AEP Ohio should be charging CRES providers RPM prices for the period from June 1, 2012 through May 31, 2015.<sup>50</sup>

AEP Ohio's cost-based prices are not competitively set and, as discussed further herein, would lead to economic inefficiencies -- and a state compensation mechanism based on cost-based prices is not consistent with Ohio law and policy. Accordingly, AEP Ohio's proposed capacity pricing should be rejected.

## **2. RPM market-based pricing is supported by sound economic principles.**

If the Commission need look beyond the Ohio law and policy that supports RPM-based pricing as the state compensation mechanism, it need look no further than AEP Ohio's own expert witnesses for confirmation of the economic benefits of market-based pricing. AEP Ohio expert Eugene Meehan has written extensively in support of market mechanisms as the best way to maximize value to customers.<sup>51</sup> Among other things, Mr. Meehan wrote that: "Competition facilitates the most efficient means of production. Competitive market pricing provides

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<sup>46</sup> See Case No. 11-346-EL-SSO, Direct Testimony of Hisham M. Choueiki, filed Aug. 4, 2011 on behalf of the Staff of the Public Utilities Commission of Ohio ("Choueiki Aug. 2011 Direct"), Staff Ex. 2, pp. 4, 10.

<sup>47</sup> See Choueiki Aug. 2011 Direct, pp. 4, 7-8.

<sup>48</sup> See Case No. 11-346-EL-SSO, Tr. Vol. X, p. 1707.

<sup>49</sup> See Case No. 11-346-EL-SSO, Direct Testimony of Hisham M. Choueiki, filed May 9, 2012 ("Choueiki May 2012 Direct"), pp. 4, 10.

<sup>50</sup> Choueiki May 2012 Direct, p. 10.

<sup>51</sup> IEU Ex. 125.



significant benefits not found under traditional regulatory pricing.”<sup>52</sup> Mr. Meehan also wrote that “price signals are more accurate within competitive markets, and can stimulate appropriate infrastructure investment. . .”<sup>53</sup> This also “shifts risks from customers to investors” and produces “more efficient results because the investor, not the ratepayer, assumes the generation investment risk.”<sup>54</sup> When discussing market access issues, like the capacity charges at issue in this case, Mr. Meehan found that market-based pricing protects customers. “Customers are protected from open-ended commitments to pay above-market costs that could not be passed through in a competitive market.”<sup>55</sup> Indeed, “competitive markets are widely held to produce the most efficient results in our economy, providing the lowest costs to customers.”<sup>56</sup> Mr. Meehan concluded that “customers would be better served by regulatory efforts directed at refining and improving the competitive model, rather than returning to cost-of-service regulation.”<sup>57</sup> AEP Ohio’s other expert witness, Frank Graves, offered similar testimony. Mr. Graves agreed with the FERC’s conclusions that competitive markets like RPM can produce advantages to electricity customers in comparison to cost-based rates by encouraging suppliers to keep costs low.<sup>58</sup> He also admitted that competition will encourage CRES providers to compete for customers, driving down margins.<sup>59</sup>

FES could not agree more with AEP Ohio’s expert witnesses and wishes that AEP Ohio listened to its own experts. RPM competitive market pricing is the correct choice for Ohio.

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<sup>52</sup> IEU Ex. 125, p. 2.

<sup>53</sup> IEU Ex. 125, p. 6

<sup>54</sup> IEU Ex. 125, p. 2.

<sup>55</sup> IEU Ex. 125, p. 11.

<sup>56</sup> IEU Ex. 125, p. 1

<sup>57</sup> IEU Ex. 125, p. 3.

<sup>58</sup> Tr. Vol. V, pp. 858-59.

<sup>59</sup> Tr. Vol. V, p. 864.

Market-based pricing is the capacity compensation methodology that encourages economically efficient behavior by all market participants and that promotes lower prices for customers. Market-based pricing will also avoid illegal and improper cross-subsidies of AEP Ohio. Regardless of whether the Commission looks at capacity pricing in the long run or in the short run, the only economically efficient price for capacity is the RPM market-based rate.

**a. RPM-based pricing is the most efficient long-run method for capacity pricing.**

In the long run, the RPM auction price to value capacity transferred from the FRR entity (AEP Ohio) to CRES providers is the only just and reasonable price in terms of economic efficiency.<sup>60</sup> It is the closest approximation to the market value of capacity available.<sup>61</sup> Pricing or transferring commodities at their market price is sound policy and is consistent with the state policy of ensuring a competitive market for electric generation, so that the value of competitive markets can be realized by Ohio consumers.<sup>62</sup>

Even leaving aside economic efficiency, RPM pricing avoids distorted incentives for AEP Ohio and CRES providers. In the long run, the RPM is designed to provide the appropriate incentives for the entry of new, cost-efficient resources and the exit of inefficient resources over a suitably long investment horizon.<sup>63</sup> The report issued by the Brattle Group, of which AEP Ohio witness Graves was a founder, acknowledges that this market is currently working very well.<sup>64</sup> On cross examination even Mr. Graves admitted that PJM is currently long on capacity, as is the AEP Ohio zone, and RPM has done a good job of incentivizing the construction of new

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<sup>60</sup> Stoddard Direct, p. 21.

<sup>61</sup> Stoddard Direct, p. 21.

<sup>62</sup> Stoddard Direct, p. 21.

<sup>63</sup> Stoddard Direct, p. 21.

<sup>64</sup> Stoddard Direct, p. 21.

capacity.<sup>65</sup> If the long-run capacity transfer price is set at anything other than RPM, CRES providers would have an incentive to divert capacity into AEP Ohio's FRR region in order to obtain the higher capacity payments.<sup>66</sup> AEP Ohio's own witnesses acknowledged this potential issue, and made several recommendations in an effort to mitigate the effect of these distorted incentives.<sup>67</sup> However, there is no reason to create the wrong price incentives and then try and mitigate the market impact of those incorrect price incentives. Instead, the Commission should implement the correct pricing as soon as possible.

AEP Ohio argues that RPM pricing is not appropriate in the long run because RPM is unable to attract the "same kinds of resources that would be preferred for long term resource planning."<sup>68</sup> As a preliminary matter, it is unclear as to why this is even relevant when AEP Ohio proposes that the above-market prices remain in effect only through June 1, 2015, after which time AEP Ohio has committed to the RPM process.<sup>69</sup> However, this argument is also flawed as a matter of policy. The RPM generates a forward-looking price that provides market signals for the construction or retirement of capacity.<sup>70</sup> Over time, however, the average RPM price is designed to provide investors in efficient new capacity resources the opportunity to earn

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<sup>65</sup> Tr. Vol. V, pp. 869-71. Mr. Graves also admitted that there was approximately 13 GW of excess capacity currently in PJM, with an additional 5-9 GW likely to come on line over the next few years. Tr. Vol. V, p. 871.

<sup>66</sup> Stoddard Direct, p. 22.

<sup>67</sup> Stoddard Direct, p. 22 (discussing Direct Testimony of Dr. Pearce, filed August 31, 2011).

<sup>68</sup> AEP Ohio Ex. 105, Testimony of Frank Graves, filed Mar. 23, 2012 ("Graves Direct"), p. 7.

<sup>69</sup> Munczinski Direct, p. 7 (acknowledging that AEP Ohio will begin participating in the RPM as of June 1, 2015).

<sup>70</sup> Stoddard Direct, pp. 48-49.

a compensatory rate of return.<sup>71</sup> This process is working, as the RPM model has incentivized more than 28,000 MW of new resources.<sup>72</sup>

AEP Ohio admits that there is no capacity shortfall in PJM through at least the 2015/16 Planning Year, and that the RPM model will continue to appropriately incentivize the construction of new capacity.<sup>73</sup> What it does not do, however, is to guarantee a specific rate of return, and certainly not in any given year.<sup>74</sup> What AEP Ohio fails to recognize is that this is intentional. RPM is specifically designed to give signals to market participants, so that when the supply of capacity greatly exceeds demand, customers benefit and new unnecessary capacity is not encouraged. When prices need to rise to stimulate investment in new capacity, the market will do that as well. AEP Ohio is seeking to avoid this market mechanism now, when RPM prices are low, and return to it in June of 2015, when RPM prices rise. Thus, AEP Ohio is offering a one-sided “bargain” to Ohio customers. It will receive cost-based prices when market prices are low, and then return to market pricing when prices rise. This is precisely the type of gamesmanship which RPM is designed to prevent and that this Commission should not allow.

AEP Ohio also argues that RPM prices fail to reflect the costs of maintaining reliability.<sup>75</sup> This is refuted by Mr. Graves’ colleagues at the Brattle Group. In the Brattle Group’s most recent study of RPM, which included all auctions held to date, Mr. Graves’ firm issued a report stating:

Our primary finding is that RPM is performing well. Despite concerns by some stakeholders, **RPM has been successful in**

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<sup>71</sup> Stoddard Direct, p. 49.

<sup>72</sup> Stoddard Direct, pp. 50-51.

<sup>73</sup> Tr. Vol. V, p. 872.

<sup>74</sup> Stoddard Direct, p. 49.

<sup>75</sup> Munczinski Direct, pp. 13-14; Graves Direct, p. 7.

**attracting and retaining cost-effective capacity sufficient to meet resource adequacy requirements.** Resource adequacy requirements have been met or exceeded in both the Regional Transmission Organization (“RTO”) and, during the last four BRAs, in all of the individual Locational Deliverability Areas (“LDAs”) at capacity prices below the net cost of new entry (“Net CONE”). Year-to-year capacity price changes have been consistent with market fundamentals, reflecting changes in the supply and demand for capacity. **RPM has reduced costs by fostering competition among all types of new and existing capacity, including demand-side resources. It has also facilitated decisions regarding the economic tradeoffs between investment in environmental retrofits on aging coal plants or their retirement.**<sup>76</sup>

Mr. Graves’ assertions to the contrary lack credibility in the face of these findings by his own firm. Indeed, Mr. Graves’ assertions are contradicted by Mr. Graves’ own reliance on these findings, which he agreed were “authoritative” regarding the RPM process, and which he has relied on in the past.<sup>77</sup> He even went so far as to encourage the Commission to rely on this report.<sup>78</sup>

AEP Ohio claims that cost-based pricing during the FRR period will encourage long term investment in new generation units in Ohio.<sup>79</sup> This simply does not make sense. Providing AEP Ohio with above-market prices during the FRR period will not encourage any long term investment because there is no investment to encourage. There is no resource shortfall between now and 2015 that AEP Ohio needs to address. In fact, AEP Ohio has no planned investment in major generating facilities prior to May 31, 2015 for which it would be “compensated” by above-market capacity charges.<sup>80</sup>

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<sup>76</sup> Stoddard Direct, Ex. RBS-6, p. I (emphasis added).

<sup>77</sup> Tr. Vol. V, p. 874.

<sup>78</sup> Tr. Vol. V, p. 874.

<sup>79</sup> Munczinski Direct, p. 14.

<sup>80</sup> Tr. Vol. I, p. 36.

Finally, AEP Ohio claims that it has avoided the “volatile and uncertain” RPM market by virtue of its status as an FRR entity, and that the volatility of the RPM auctions will prevent new generation investment.<sup>81</sup> This argument fails for at least two reasons. First, AEP Ohio did charge RPM prices in the past and so its status as an FRR entity provided no “stability” from the “volatile” RPM prices. Second, the argument fails because market capacity prices are now known with certainty and AEP Ohio has elected to rely on the RPM market, as it has in the past, starting June 1, 2015.<sup>82</sup> AEP Ohio expert Graves’ Brattle Group also supported the certainty of RPM market prices.<sup>83</sup> The Brattle Group found that the market incentives caused by changing prices send valuable signals to the market, and that these signals prevent “both severe shortages and costly excess of supply.”<sup>84</sup> More importantly, although RPM prices change each year, they are known with certainty today. They are not volatile in any sense of the word since customers can plan for the entire period today, in comparison with the results of AEP Ohio’s “formula” rate which will not be determined until well into the future.<sup>85</sup> Moreover, AEP Ohio’s proposed change based on 2010 data is over 400% higher than the average RPM billed rate.<sup>86</sup> For the next three years, this means that AEP Ohio’s distribution customers would pay an additional \$2.8 billion premium for the privilege of avoiding these “volatile” RPM prices.<sup>87</sup> Paying a 400% markup over market as “insurance” against volatile prices, when the volatile prices are already

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<sup>81</sup> Lesser Direct, p. 35. As discussed above, AEP Ohio charged CRES providers RPM based prices from 2007 until the instant case.

<sup>82</sup> Lesser Direct, p. 31.

<sup>83</sup> Lesser Direct, p. 31.

<sup>84</sup> Lesser Direct, p. 32.

<sup>85</sup> Tr. Vol. II, p. 260 (“I’ll even give you that they won’t just could change but they will change.”)

<sup>86</sup> Lesser Direct, p. 36.

<sup>87</sup> Lesser Direct, p. 36.

known, makes no economic sense.<sup>88</sup> There is accordingly no long run volatility issue with RPM pricing.

**b. RPM-based pricing is the most efficient short-run method for capacity pricing.**

Pricing capacity at the RPM auction price maximizes economic efficiency by pricing or transferring commodities at their market price, so that there is a rational trade-off between the value captured by utilizing a good versus selling it in the market.<sup>89</sup> In the short-run, AEP Ohio's proposal provides for above-market payments to AEP Ohio from competitive suppliers. The use of a higher than market price both discourages and slows the development of the competitive market, and also supplies a competitive advantage now, and going forward, for AEP Ohio in its ability to compete for retail customers.<sup>90</sup> Moreover, pricing at something other than the market rate would create significant distortions by effectively encouraging and justifying behavior that would otherwise be equivalent to economic withholding.<sup>91</sup> RPM market-based pricing avoids subsidies, as the payments are equal to the opportunity costs that AEP Ohio has for a market disposition (not an assumed regulatory disposition) of the capacity.<sup>92</sup> If AEP Ohio were free to sell this capacity, the best approximation of what it would receive is the RPM price.<sup>93</sup>

AEP Ohio's proposal also is inefficient because it will almost surely lead to higher retail prices for shopping customers.<sup>94</sup> CRES providers cannot simply "eat" the higher costs that AEP

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<sup>88</sup> Lesser Direct, p. 36.

<sup>89</sup> Stoddard Direct, p. 21.

<sup>90</sup> Stoddard Direct, p. 22.

<sup>91</sup> Stoddard Direct, p. 22.

<sup>92</sup> Stoddard Direct, p. 46.

<sup>93</sup> Stoddard Direct, p. 46.

<sup>94</sup> Stoddard Direct, p. 48.

Ohio's proposed rate would impose, and this would necessarily increase retail prices for shopping customers in the near term.<sup>95</sup> Higher retail prices would create a drag on Ohio's economy at a time when Ohio is rebounding from a severe recession. It is not efficient to create a drag on economic activity through higher retail prices when the competitive market is willing and able to serve these customers at lower rates.

From an economic efficiency perspective, there also is a significant problem with AEP Ohio's proposed approach for the purchase of capacity during the 17-month Bridge Period (the period from corporate separation on January 1, 2014 through June 1, 2015). AEP Ohio, which at that time will not own capacity resources, does not intend to go to market to purchase or price the capacity it will use to serve Ohio customers.<sup>96</sup> Instead, AEP Ohio proposes to purchase capacity during the Bridge Period from AEP Generation Resources.<sup>97</sup> There is a fundamental flaw in this proposal, because if AEP Ohio no longer owns the generation resources then it is not economically efficient to force customers to pay above-market rates for capacity under any theory. Charging an above-market price for capacity after separation would be a clear cross-subsidy in violation of FERC policy, Ohio law, and AEP Ohio's own corporate separation plan.<sup>98</sup>

**c. RPM-based pricing does not subsidize CRES providers.**

AEP Ohio has alleged that under an RPM pricing model the FRR entity (AEP Ohio) could be subsidizing (or be subsidized by) a CRES provider if the RPM rate is above or below

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<sup>95</sup> Stoddard Direct, p. 48; *see* Section C.2(a) *infra* (citing CRES provider witnesses explaining the impact of the proposed \$355/MW-day capacity price on their (in)ability to offer savings).

<sup>96</sup> Tr. Vol. I, p. 41.

<sup>97</sup> Tr. Vol. I, p. 41.

<sup>98</sup> Lesser Direct, p. 12.



the FRR entity's costs.<sup>99</sup> The core fallacy of AEP Ohio's argument is the presumption that it is entitled to full embedded costs.<sup>100</sup> As discussed above, this argument fails for numerous reasons.<sup>101</sup> Moreover, the principal beneficiaries of a return to the lower RPM rate will not be the CRES providers themselves but rather their customers: Ohio consumers. Customers choose retail suppliers in large part because of the opportunity for savings—that is, on price. Any CRES supplier that seeks to charge its customers a high price that does not reflect the lower, market price of capacity will quickly find that its customers have left for lower-priced offerings.<sup>102</sup> Thus AEP Ohio's argument that charging a market price to CRES providers will create a windfall for the retailers is ridiculous. It is the customer who will benefit.

RPM pricing does not subsidize CRES providers because it represents what AEP Ohio would receive for its capacity if it did not have a monopoly. AEP Ohio would not be subsidizing CRES providers by providing capacity below AEP Ohio's purported "costs" because, among other reasons, a subsidy must be determined by reference to the market price. What is AEP Ohio's foregone revenue from having tied up an additional MW of capacity to service CRES load?<sup>103</sup> In other words, what is the price which AEP Ohio could obtain from a willing buyer? The answer to this question is the RPM market rate.<sup>104</sup> If AEP Ohio sold this capacity in the auction, that is the rate it would receive. If AEP Ohio sold this capacity bilaterally, there is no reason why the buyer would be willing to pay AEP Ohio its embedded costs rather than the

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<sup>99</sup> Munczinski Direct, pp. 7-8; Lesser Direct, p. 27.

<sup>100</sup> Stoddard Direct, pp. 41-42.

<sup>101</sup> See also Stoddard Direct, pp. 46-47.

<sup>102</sup> Tr. Vol. VIII, pp. 1660-1661; see also Section C.2(a), *infra*.

<sup>103</sup> Stoddard Direct, p. 46.

<sup>104</sup> Stoddard Direct, p. 46; Lesser Direct, p. 29.

market rate.<sup>105</sup> Under any realistic scenario, the maximum price AEP Ohio could get for its capacity, when sold to a willing buyer, is the RPM PJM market rate.<sup>106</sup> Therefore, charging rates above what AEP Ohio could otherwise receive for this capacity is not a subsidy to CRES providers. If anything, and discussed further herein, it is a subsidy to AEP Ohio.

### **3. Contrary to AEP Ohio's Testimony, AEP Ohio's Return On Equity Is More Than Sufficient Under RPM Pricing.**

AEP Ohio witness Allen presented an analysis purporting to show the effect of RPM pricing on AEP Ohio's return on equity. Mr. Allen presented estimates of financial impact under RPM prices and under the ESP II Partial Stipulation two-tiered pricing, which was rejected by the Commission. Under RPM prices, Mr. Allen testified that AEP Ohio's return on equity would be 7.6% in 2012 and 2.4% in 2013.<sup>107</sup> Under the rejected Partial Stipulation pricing (which included all of the terms and conditions to which AEP Ohio had agreed), Mr. Allen estimated that AEP Ohio's return on equity would be 10.4% in 2012 and 7.3% in 2013.<sup>108</sup> Mr. Allen did not estimate a return on equity under AEP Ohio's proposed \$355.72/MW-day capacity pricing for 2012, but estimated a 12.2% return on equity for 2013 with this capacity pricing.<sup>109</sup> If Mr. Allen's analysis was done correctly, to reflect the impact of the RSR and DIR, AEP Ohio's ROE also would be 13.4% in 2012 and 13.7% in 2013.<sup>110</sup>

Mr. Allen's analysis is flawed and therefore understates what the estimated return on equity would be under the various scenarios because his analysis significantly overstates both the

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<sup>105</sup> Stoddard Direct, p. 46.

<sup>106</sup> Stoddard Direct, p. 46; Lesser Direct, p. 29.

<sup>107</sup> AEP Ohio Ex. 104, Direct Testimony of William A. Allen, filed Mar. 23, 2012 ("Allen Direct"), p. 3.

<sup>108</sup> AEP Ohio Ex. 142, Rebuttal Testimony of William A. Allen, filed May 11, 2012 ("Allen Rebuttal"), Ex. WAA-R8.

<sup>109</sup> Tr. Vol. III, p. 583; Allen Rebuttal, Ex. WAA-R8.

<sup>110</sup> FES Ex. 122 (Scenario 2).

possible rate of shopping and the speed at which that shopping could take place. Mr. Allen's analysis is also flawed because it assumes that AEP Ohio is entitled to a specific return on equity for its generation assets under Ohio law. This is simply not true. AEP Ohio is now "fully on its own in the competitive market" under Ohio law.<sup>111</sup> If AEP Ohio needs additional revenue for distribution reasons, then it should file a distribution rate case.<sup>112</sup> Otherwise, Mr. Allen's flawed and irrelevant analysis should be rejected as an improper attempt to avoid corporate separation.

**a. Mr. Allen's shopping assumptions are unrealistic.**

Mr. Allen's analysis is flawed because, among other things, his assumptions are unrealistic. To create his comparison between RPM pricing and the Partial Stipulation pricing, Mr. Allen assumed that under RPM pricing AEP Ohio would immediately see dramatically higher shopping.<sup>113</sup> Mr. Allen's RPM analysis assumed shopping of 65% (residential), 80% (commercial), and 90% (industrial) by the end of 2012.<sup>114</sup> On cross examination, Mr. Allen acknowledged that this shopping assumption created a large portion of the difference in the returns on equity between these two scenarios he examined.<sup>115</sup> Mr. Allen also acknowledged that if the amount of shopping was less than he had projected, AEP Ohio's return on equity would increase.<sup>116</sup> As only 26.1% of AEP Ohio's load had switched as of March 1, 2012, with an additional 2.2% pending switches and 8.4% having provided notice of intent to switch for a

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<sup>111</sup> R.C. § 4928.38.

<sup>112</sup> The Commission has made clear that AEP Ohio may seek an adjustment to base distribution rates prior to June 1, 2015. Case No. 11-351-EL-AIR, Entry dated March 21, 2012, ¶ 7.

<sup>113</sup> Allen Direct, pp. 4-5.

<sup>114</sup> Allen Direct, pp. 4-5.

<sup>115</sup> Tr. Vol. III, p. 585.

<sup>116</sup> See Tr. Vol. III, p. 585 (acknowledging that if shopping was less than his projections, the difference between AEP Ohio's return on equity under the two-tiered capacity prices and its return on equity under RPM prices would be less).

total of 36.7% having switched or evidenced an intent to switch, Mr. Allen's shopping estimates are unrealistic.<sup>117</sup>

Mr. Allen claims to have based his shopping assumption on his review of shopping statistics in Ohio jurisdictions.<sup>118</sup> However, these data do not support Mr. Allen's claim. There is only one utility in Ohio currently experiencing shopping at 65% (the figure used by AEP Ohio) or higher for residential load.<sup>119</sup> Mr. Allen also admitted on cross examination that the switching percentage for all residential shopping in Ohio is only 33%.<sup>120</sup> Despite these admissions, Mr. Allen's RPM analysis assumes that AEP Ohio will see residential shopping of 65% by the end of 2012. It is unreasonable and disingenuous to assume that residential shopping will increase from 9.5% to 65% by the end of this year.<sup>121</sup>

Similarly, Mr. Allen's assumptions regarding the speed at which shopping will take place are unrealistic. Mr. Allen assumes dramatic increases in shopping by the end of 2012 (i.e., from 9.5% to 65%), and this is simply not practical during this short period. There is no historical support for Mr. Allen's assumption since an increase of this magnitude has not been seen before in Ohio. The largest increase identified by AEP Ohio at hearing was in Toledo Edison's service

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<sup>117</sup> Mr. Allen did not use these same assumptions in his Partial Stipulation pricing analysis. Allen Direct, p. 5. Instead, Mr. Allen assumed that 23% of the load would shop in 2012 and 36% of the load would shop in 2013. Tr. Vol. III, p. 585.

<sup>118</sup> Tr. Vol. III, p. 589.

<sup>119</sup> Tr. Vol. III, p. 592. CEI is the only utility currently experiencing residential shopping at a level greater than 65%, and this abnormally high shopping is due to high levels of governmental aggregation seen in CEI's service territory.

<sup>120</sup> Tr. Vol. III, p. 592.

<sup>121</sup> Tr. Vol. III, p. 606. Mr. Allen also claims that shopping for commercial customers will increase from 48% to 80%, and that industrial customer shopping will increase from 40% to 90%. These rates are similarly unrealistic, both due to the sheer size of these shopping assumptions as seen in other areas and the speed at which Mr. Allen assumes this shopping will take place.

territory in 2009, a jump in residential shopping from 19% to 55%.<sup>122</sup> Mr. Allen was not familiar with basic facts regarding this increase, which were subsequently explained by FES witness Banks.<sup>123</sup> Mr. Allen was not familiar with the Northwest Ohio Aggregation Coalition, or the fact that the city of Toledo is a member of that coalition.<sup>124</sup> Mr. Allen was not familiar with the CRES provider contract signed in 2009 by the Northwest Ohio Aggregation Coalition, which accounted for the significant increase in shopping.<sup>125</sup> Mr. Allen was similarly unfamiliar with the Northeast Ohio Public Energy Council, and the fact that it represents between 125 and 150 communities in the Ohio Edison service territory and also accounts for a significant amount of the shopping that territory.<sup>126</sup> In light of his unfamiliarity with basic information regarding this shopping history, his estimates of the speed at which shopping will take place in the absence of these two significant organizations have no probative value.

It is unreasonable for AEP Ohio's customers to switch at the level or speed forecast by Mr. Allen, and he was not familiar with the basic and essential facts related to the (much smaller) shopping increases seen in other territories. Therefore, the Commission should accord his shopping assumptions no weight.

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<sup>122</sup> Tr. Vol. III, p. 611.

<sup>123</sup> Tr. Vol. VIII, pp. 1652-1656.

<sup>124</sup> Tr. Vol. III, pp 612-13.

<sup>125</sup> Tr. Vol. III, p. 614; Tr. Vol. VIII, p. 1656 (FES witness Banks explaining that the NOAC contract, which included multiple communities including Toledo, would account for the large increase in aggregation percentages at that time).

<sup>126</sup> Tr. Vol. III, pp. 614-15; Tr. Vol. VIII, p. 1655 (FES witness Banks explaining that the NOPEC contract represents approximately 130 communities and their residents and small commercial customers, which would account for the increase in shopping in the 30% range).

**b. If AEP Ohio has a return on equity problem affecting reliability, it should seek a distribution rate increase.**

AEP Ohio's return on equity for generation activities is simply not relevant to this case. Ohio law is clear that at the end of the market transition period, which was December 31, 2005, "the utility shall be fully on its own in the competitive market."<sup>127</sup> There is no legal justification to consider the impact on AEP Ohio's return on equity resulting from generation-related costs which are required by law to be recovered in the competitive market.

More fundamentally, Ohio law requires corporate separation of the generation and distribution functions.<sup>128</sup> While AEP Ohio has up to now proceeded with a limited form of functional separation, at minimum this functional separation should be respected. If AEP Ohio has a distribution revenue issue affecting reliability, then that is a distribution issue, which should be addressed in a distribution rate case. It is inappropriate for AEP Ohio to ask the Commission to award it additional funds for the generation side of its business – a line of business which must be at least functionally separate from its distribution side – to maintain reliability for customers. AEP Ohio's reliance on generation revenues to support its distribution operations because it is a "bundled company"<sup>129</sup> is a violation of Ohio law requiring corporate separation.

AEP Ohio seeks a guarantee from this Commission that it will recover a minimum rate of return. It seeks protection from the competitive market prices for generation service. There is no reason to provide AEP Ohio with this type of risk-free, preferential treatment. No other generator in PJM receives this type of cost-based recovery -- nor should they.<sup>130</sup> Other

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<sup>127</sup> R.C. § 4928.38.

<sup>128</sup> R.C. §§ 4928.03; 4928.17.

<sup>129</sup> See Tr. Vol. I, pp. 32-34, 73.

<sup>130</sup> Stoddard Direct, p. 23.

generators are instead forced to properly and efficiently manage their costs and assets and operate subject to the forces of the competitive market. AEP Ohio should not be given any special, preferential treatment, and should be forced to deal with the same market as every other generator.

**B. Even if Cost-Based Pricing Were Appropriate (And It Is Not), AEP Ohio Has Dramatically Overstated Its Costs.**

As discussed in detail above, RPM pricing is the proper price for capacity in Ohio's competitive market. AEP Ohio's purported costs are irrelevant to the market value of AEP Ohio's capacity and there is no reason why CRES providers and customers should be forced to pay above-market rates for capacity. If the Commission is inclined to consider AEP Ohio's costs, then it should only consider appropriate costs and should include an appropriate offset for energy sales. AEP Ohio's formula<sup>131</sup> does neither, and therefore dramatically overstates its costs by claiming an entitlement to \$355.72/MW-day.<sup>132</sup> The proposed rate: (1) is not based on the costs associated with the capacity provided; (2) includes all costs, as opposed to only those avoidable costs that are relevant in economic decision making; (3) includes stranded costs which are prohibited from recovery by Ohio law; and (4) fails to include an appropriate offset for energy sales.

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<sup>131</sup> AEP Ohio claims that its "formula" has been subject to "regulatory scrutiny" by FERC and is therefore entitled to deference. Pearce Direct, p. 9. There are several significant flaws with this argument. Most notably, the formula rate proposed by AEP Ohio involved a contract with two municipalities who purchased both capacity and full requirements energy from the AEP affiliate. Tr. Vol. II, pp. 249-50. There is a significant difference between buying cost-based capacity and energy and being forced to pay cost-based capacity and market-based energy. FERC has never approved this formula rate for a customer purchasing only capacity. Tr. Vol. II, pp. 252-53. Moreover, this formula rate involved a settlement which specifically stated that it should not be considered as precedent. Tr. Vol. II, p. 251. Based on these two major flaws, AEP Ohio's formula rate is not entitled to any deference by the Commission.

<sup>132</sup> Pearce Direct, p. 21.

**1. AEP Ohio Has Not Dedicated Ohio-Owned Units To Ohio Customers, And Therefore AEP Ohio's Formula Rate Must Be Rejected.**

The underlying assumption supporting Dr. Pearce's proposed capacity charge is that the costs of AEP Ohio's generating facilities are directly related to the capacity provided to shopping load in Ohio. However, it simply is not true that AEP Ohio's generating facilities are "dedicated to Ohio customers."<sup>133</sup> Dr. Pearce's FERC formula rate is invalid because, among other things, AEP Ohio has not dedicated any capacity to Ohio customers. Instead, the FRR election was made by all of the AEP East entities, using the assets of all AEP East entities.<sup>134</sup> The pooled capacity of all AEP East entities is used to meet the capacity requirements of all load in the AEP East zone.<sup>135</sup> Thus, there is no evidence regarding the costs of the capacity supporting shopping load in Ohio. There is no way to determine the costs of the assets which are actually being utilized by customers in AEP Ohio's service territory. As AEP Ohio has failed to establish the cost of the assets actually used to provide capacity to Ohio customers, it would be inappropriate to charge Ohio customers a formula rate which is based on the costs of assets which may not even be used by Ohio customers.

**2. AEP Ohio's Formula Inappropriately Includes All Fixed Costs As Opposed To Only Avoidable Costs.**

AEP Ohio's formula seeks recovery for all fixed costs related to capacity. Allowing all fixed costs of capacity to be recovered, as opposed to simply avoidable costs, is inappropriate and would lead to a significant over-recovery for AEP Ohio. If AEP Ohio's formula is accepted, AEP Ohio would be the only capacity supplier in PJM that could charge shopping customers its

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<sup>133</sup> Munczinski Direct, p. 10.

<sup>134</sup> Stoddard Direct, p. 9.

<sup>135</sup> Tr. Vol. I, pp. 56-58.



full embedded costs for generation.<sup>136</sup> FES witness Stoddard was one of the drafters of this section of the RAA and offered extensive testimony regarding the impropriety of AEP Ohio's proposed embedded cost pricing.<sup>137</sup>

**a. The RPM Settlement Agreement and the RAA do not permit recovery of embedded costs for CRES Providers.**

RPM prices are almost entirely a product of the BRA. PJM buys capacity as determined by the needs of the Variable Resource Requirement.<sup>138</sup> The supply is determined by offers to sell capacity which are qualified to participate in the BRA.<sup>139</sup> Owners of existing capacity resources are subject to a must offer obligation into the RPM markets, and these resources are subject to offer caps.<sup>140</sup> These offers of capacity must be based on the costs that a resource's owner can avoid by retiring or mothballing the resource, and are referred to as the Avoidable Cost Rate ("ACR").<sup>141</sup>

Offers are limited to the facilities' ACR value to replicate the bidding behavior which would be expected in a competitive environment.<sup>142</sup> In the absence of market power, individual suppliers would be expected to offer capacity resources at their short-term "to go" costs, i.e., the costs that could be avoided by either retiring or "mothballing" an existing unit for a year.<sup>143</sup> The ACR values used in the PJM auction process reflect an attempt to administratively set the determination of such "to go" costs, allowing only for typical out-of-pocket costs incurred by

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<sup>136</sup> Tr. Vol. V, p. 859; Stoddard Direct, p. 19.

<sup>137</sup> Tr. Vol. VIII, pp. 1647-48; *see generally* Stoddard Direct.

<sup>138</sup> Stoddard Direct, p. 11.

<sup>139</sup> Stoddard Direct, p. 11.

<sup>140</sup> Stoddard Direct, pp. 11-12.

<sup>141</sup> Stoddard Direct, p. 12, RAA Section 6.8, Attachment DD.

<sup>142</sup> Stoddard Direct, p. 12.

<sup>143</sup> Stoddard Direct, p. 12.

keeping a resource in service.<sup>144</sup> This differs from “embedded costs,” which include both the “to go” costs as well as other nonavoidable costs such as depreciation, amortization, taxes, and corporate costs.<sup>145</sup> The RAA only permits ACR values to be used because this is the economically efficient way to price assets. So long as a business sells a product for more than it costs to make it – the “to go” cost – then it is earning some margin to cover fixed costs and possibly enough to generate a return on equity.<sup>146</sup>

To calculate the ACR values used in the RPM auction, the Independent Market Monitor (“IMM”) calculates the ACR values for each existing resource.<sup>147</sup> The IMM calculates this value by determining the benchmark costs for that resource, and then subtracting its estimate of the net earnings from the sale of energy and ancillary services, valued at PJM spot market prices, over the prior three calendar years (the “E&AS Offset”).<sup>148</sup> When calculating the E&AS Offset, the IMM uses the entire net margin on the sale of energy and ancillary services, without any reduction (such as the 40% and then 50% reductions proposed by AEP Ohio due to the Pool and a split with shareholders) for sharing among AEP entities.<sup>149</sup>

AEP Ohio repeatedly claims that the FRR alternative allows it to recover its embedded costs, rather than the “to go” costs.<sup>150</sup> This is incorrect. Nothing in the RPM Tariff or the RAA

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<sup>144</sup> Stoddard Direct, p. 12.

<sup>145</sup> Stoddard Direct, pp. 12-13.

<sup>146</sup> Stoddard Direct, p. 13.

<sup>147</sup> Stoddard Direct, p. 14.

<sup>148</sup> Stoddard Direct, pp. 14-15.

<sup>149</sup> Tr. Vol. II, p. 391; Pearce Direct, pp. 17-18.

<sup>150</sup> See, e.g., Horton Direct, p. 5 (“FRR mechanism allowed it to continue to recover its *embedded* generation costs associated with the customers it serves through existing Commission approved rate structures.”); *Id.*, p. 10 (“the stakeholders [in the RPM settlement] agreed upon another method under which the level of capacity compensation would be based on the FRR’s embedded capacity cost.”)

authorizes the recovery of embedded costs.<sup>151</sup> AEP Ohio admits that “embedded costs” is a concept nowhere to be found in the RPM Tariff or the RAA, as compared to the numerous references to “avoidable costs.”<sup>152</sup> In the BRA, existing resources may not include costs in their offers such as return on and of capital, interest, property taxes, or depreciation. Only the costs explicitly enumerated in the ACR definition may be included, which necessarily excludes AEP Ohio’s claimed full embedded costs.<sup>153</sup>

If the Commission were to allow AEP Ohio to charge CRES providers any rate other than the RPM clearing price, AEP Ohio would be the only capacity supplier in PJM that could charge shopping customers its full embedded costs for generation.<sup>154</sup> Here in Ohio, Duke Energy Ohio charges RPM prices, as does the Dayton Power & Light Company.<sup>155</sup> FirstEnergy’s Ohio utilities transitioned to PJM after the BRA had been conducted for some of the future planning years, and so this load was procured via a separate PJM-administered FRR auction. CRES providers are charged that auction price, which is almost identical to the RPM prices.<sup>156</sup> There is simply no support for AEP Ohio’s claim that the RAA authorizes recovery of full embedded costs. The BRA is designed to collect only marginal “to go” costs less an offset for energy receipts, and Ohio should not adopt an unjust recovery method which ignores these basic precepts.

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<sup>151</sup> Stoddard Direct, p. 16.

<sup>152</sup> Tr. Vol. II, pp. 386-87; Stoddard Direct, p. 16.

<sup>153</sup> Stoddard Direct, p. 16.

<sup>154</sup> Stoddard Direct, p. 19.

<sup>155</sup> Stoddard Direct, pp. 19-20.

<sup>156</sup> Stoddard Direct, p. 20 (“\$108.89 for planning year 11/12, and \$20.46 for 12/13, compared to the RPM BRA prices of \$110.04 for 11/12 and \$16.46 in 12/13”).

As the RPM Settlement Agreement and the RAA do not authorize recovery of full embedded costs, and include provisions making clear that avoidable costs are the only relevant measure, there is no justification for AEP Ohio's proposal.

**b. Charging a full embedded cost-based capacity rate while charging market rates for energy violates sound regulatory policy.**

Leaving aside the lack of RPM or RAA support for recovery of full embedded costs, AEP Ohio's formula is flawed for a more fundamental reason. The state compensation mechanism is part of a competitive landscape. As discussed in detail above, if CRES providers are forced to pay for capacity at AEP Ohio's embedded cost, while also having to pay market prices for energy, then CRES providers and the customers they serve will be significantly disadvantaged.<sup>157</sup>

The RPM market limits offers from existing resources based on the costs that a resource's owner could avoid by retiring or mothballing the resource, the ACR.<sup>158</sup> The purpose of limiting offers at the "to go" cost is to more accurately replicate the competitive market. As long as a business can sell a product for more than its marginal cost, then it is earning a margin to cover its fixed costs through that sale.<sup>159</sup> Producers earn a margin based on the difference between their marginal cost and the prevailing market price.<sup>160</sup> In wholesale markets for capacity, all resources are paid the clearing price, rather than their offer price.<sup>161</sup> The market clearing price is

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<sup>157</sup> Stoddard Direct, pp. 17-18.

<sup>158</sup> Stoddard Direct, p. 12.

<sup>159</sup> Stoddard Direct, p. 13.

<sup>160</sup> Stoddard Direct, p. 27.

<sup>161</sup> Stoddard Direct, p. 27.

set by the offer from the highest-cost resource selected, which means that lower-cost resources earn a margin above their marginal costs.<sup>162</sup> This margin contributes to paying fixed costs.<sup>163</sup>

FES witness Stoddard testified that the proper measurement of AEP Ohio's "costs" would be to determine these "costs" by looking at the same calculation used to determine the maximum offer price from AEP Ohio's capacity resources, which is the "to go" cost less expected revenue in excess of variable cost.<sup>164</sup> This metric is the best available measure of the net cost that a competitive wholesale generator would seek, at minimum, to recover through capacity charges.<sup>165</sup>

Using non-confidential data and models developed by CRA, Mr. Stoddard examined the maximum offer price for each resource included in the AEP Ohio FRR capacity plan. To replicate the process used by the IMM in determining the offer cap for each resource, Mr. Stoddard followed the methodology from Schedule DD of PJM's Tariff.<sup>166</sup> Mr. Stoddard computed the maximum allowable offer price by examining: (1) the maximum ACR, including where applicable (2) the Avoidable Project Investment Recovery Rate ("APIR"), minus (3) the E&AS Offset. The net capacity cost for each resource is the sum of its ACR and its APIR, reduced by its E&AS Offset.<sup>167</sup> A resource is allowed to offer into the RPM auctions at zero even if its E&AS Offset exceeds the resources' ACR.<sup>168</sup>

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<sup>162</sup> Stoddard Direct, pp. 27-28.

<sup>163</sup> Stoddard Direct, pp. 27-28.

<sup>164</sup> Stoddard Direct, p. 29.

<sup>165</sup> Stoddard Direct, p. 29.

<sup>166</sup> Stoddard Direct, p. 30.

<sup>167</sup> See Stoddard Direct, pp. 32-33 (explaining calculations).

<sup>168</sup> Stoddard Direct, p. 35.

Mr. Stoddard's calculations are presented as Exhibit RBS-5. If AEP Ohio's entire FRR portfolio is considered, AEP Ohio's generation fleet has an overall negative net capacity cost of (\$51.05/MW-day).<sup>169</sup> In other words, AEP Ohio is made whole with energy revenues even if the capacity rate charged to CRES providers is zero because its operating revenues will exceed operating costs. This implies that a unit would earn a contribution margin from energy sales even if it received no capacity payment at all.<sup>170</sup> However, when participating in the RPM market, a unit with a negative ACR would have a floor of zero for its offer and would receive the RPM clearing price, making the "negative" units even more profitable.

The fleet-average cost figure of (\$51.05)/MW-day is well below the 41-month average BRA supplier price of \$63.23/MW-day.<sup>171</sup> Accordingly, the RPM rate is more than compensatory to cover the net going-forward costs of AEP Ohio's capacity resources over the course of the next three planning years.

**3. AEP Ohio's Calculation Is Incorrect Because AEP Ohio Previously Agreed To Waive Recovery Of Stranded Costs And Already Recovered Other Costs.**

**a. S.B. 3 required that all generation plant investment after January 1, 2001 be recovered solely in the market.**

Under S.B. 3, all generation plant investment after January 1, 2001 was to be recovered solely in the market.<sup>172</sup> AEP Ohio has repeatedly and publicly acknowledged that these costs were stranded.<sup>173</sup> Each electric utility was given an opportunity during a transition period to recover any previously-sunk costs in their generating facilities (i.e., costs incurred prior to the

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<sup>169</sup> Stoddard Direct, p. 34.

<sup>170</sup> Stoddard Direct, p. 35.

<sup>171</sup> Stoddard Direct, p. 39.

<sup>172</sup> R.C. § 4928.01(A)(28); R.C. § 4928.38 ("the utility shall be fully on its own in the competitive market."); Lesser Direct, p. 10.

<sup>173</sup> See FES Ex. 105; 106 (testimony and Stipulation in Case No. 99-1729/173); Tr. Vol. I, pp. 49-50.

transition date of January 1, 2001) that would be uneconomic or “stranded” in competitive markets.<sup>174</sup> Because S.B. 3 provided a clear demarcation date between pre-transition and post-transition generation costs, any cost-based capacity charges levied by AEP Ohio could apply only to generating plant that was in-service on or before December 31, 2000, the day before the transition date of January 1, 2001, and only then if AEP Ohio had not waived recovery and/or already fully recovered these costs during the transition period.<sup>175</sup> By statutory mandate, that transition period is long over.

Stranded costs are relevant to the capacity charge AEP Ohio proposes to charge all customers for three reasons.<sup>176</sup> First, stranded costs hinge on the net undepreciated book value of generating plant-in-service (“GPIS”).<sup>177</sup> If the market value of a generating asset is greater than its net GPIS, then there are no stranded costs associated with that asset.<sup>178</sup> Second, because R.C. § 4928.01(A)(28) defined the starting date of competitive retail electric service as January 1, 2001, all generating plant investment subsequent to that date must be recovered from the market, rather than in cost-based rates.<sup>179</sup> Thus, the only legitimate embedded capacity costs AEP Ohio could have recovered as stranded costs were those costs related to generating plant that was in service prior to the start of competitive retail service.<sup>180</sup> Third, under AEP Ohio’s proposed corporate separation agreement, AEP Ohio will transfer all of its existing generating

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<sup>174</sup> R.C. § 4928.38-40; Lesser Direct, pp. 10-11 (*citing* Case Nos. 99-1730-EL-ETP and 99-1731-EL-ETP, the “ETP Proceeding”).

<sup>175</sup> Lesser Direct, p. 11.

<sup>176</sup> Lesser Direct, p. 11.

<sup>177</sup> Lesser Direct, p. 11.

<sup>178</sup> R.C. § 4928.39(C); *see also* Lesser Direct, p. 11.

<sup>179</sup> Lesser Direct, p. 11.

<sup>180</sup> Lesser Direct, p. 11.

assets to an unregulated generation company, AEP Generation Resources, Inc.<sup>181</sup> The expected date of this transfer is December 31, 2013 “or other such date as ordered by the FERC.”<sup>182</sup> After the transfer, AEP Generation Resources cannot charge AEP Ohio an above-market price for capacity because charging customers an above-market price from an affiliate would constitute a prohibited cross-subsidy.<sup>183</sup>

Under S.B. 3, stranded cost recovery took two forms, which became known as Generation Transition Costs (“GTCs”) and Regulatory Transition Costs (“RTCs”).<sup>184</sup> An electric utility could recover GTCs through a transition charge during the transition period, provided the costs satisfied statutory requirements.<sup>185</sup> At the end of the transition period, which was December 31, 2005, “the utility shall be fully on its own in the competitive market.”<sup>186</sup> Similarly, an electric utility could recover its RTCs both during the transition period and for several years thereafter, but in any case no later than December 31, 2010.<sup>187</sup> For AEP Ohio, the transition period for recovering RTCs ended as of December 31, 2008.<sup>188</sup> Thus, AEP Ohio’s ability to recover stranded costs of its generating facilities – i.e., any costs that would not be fully recovered through the competitive market after the transition period – ended more than six years ago for GTCs and more than three years ago for RTCs.<sup>189</sup> Under the transition provisions of

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<sup>181</sup> Lesser Direct, p. 12.

<sup>182</sup> Lesser Direct, p. 12.

<sup>183</sup> Lesser Direct, p. 12 (*citing* 2012 Corporate Separation Plan, Attachment A, Item 1(3) “Cross-subsidies between an electric utility and its affiliates are prohibited. An electric utility’s operating employees and those of its affiliates shall function independently of each other.”)

<sup>184</sup> R.C. § 4928.39; *see also* ETP Proceeding.

<sup>185</sup> R.C. §§ 4928.40, 4928.31; Lesser Direct, p. 12.

<sup>186</sup> R.C. § 4928.38.

<sup>187</sup> R.C. § 4928.40.

<sup>188</sup> ETP Proceeding, Stipulation (May 8, 2000) at Att. 1.

<sup>189</sup> Lesser Direct, p. 13.



S.B. 3, the PUCO was, and is, prohibited from authorizing “the receipt of transition revenues *or any equivalent revenues* by an electric utility except as expressly authorized.”<sup>190</sup>

AEP Ohio has recognized that the transition period has ended, and that it can no longer recover stranded costs. In its 2012 Corporate Separation Plan, AEP states:

[OPCo] seeks to transfer its generating assets to an affiliate within the same parent corporation, in compliance with the mandate of R.C. 4928.17. Under SB 3, all of these generation assets were subjected to market and EDUs therefore were given a temporary opportunity to recover stranded generation investments during a transition period. **That transition period is over. EDUs can no longer recover stranded generation investments,** and transferring the generation assets based on an arbitrary determination of their current fair market value rather than net book value would be inappropriate.<sup>191</sup>

There is nothing in AEP Ohio’s 2012 Corporate Separation Plan stating that stranded costs can be recovered indirectly from non-SSO customers through CRES providers acting as “middlemen” in the transaction.<sup>192</sup>

The provisions of S.B. 3 do not pertain only to retail service. Instead, Ohio law is clear that “the utility shall be on its own in the competitive market.”<sup>193</sup> The prohibition on collection of transition charges after the transition period is not limited to retail sales. Ohio law does not say that a utility is on its own in the competitive market *except that the Commission can authorize above-market charges to CRES providers*. A utility is simply prohibited from collecting stranded costs from any source. There is no statutory authority and it makes no sense to claim that AEP Ohio is prohibited from recovering stranded capacity costs directly from its

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<sup>190</sup> See R.C. § 4928.38 (emphasis added).

<sup>191</sup> In the Matter of the Application of Ohio Power Company for Approval of Full Legal Corporate Separation and Amendments To Its Corporate Separation Plan, Case No. 12-1126-EL-UNC, Application, filed Mar. 30, 2012 (“2012 Corporate Separation Plan”), p. 7 (emphasis added).

<sup>192</sup> Lesser Direct, pp. 14-15.

<sup>193</sup> R.C. § 4928.38.

retail distribution customers, but is somehow allowed to recover these same stranded costs, from these same retail customers, as long as the costs are first charged to CRES providers who AEP Ohio refers to as “middlemen.”<sup>194</sup> The mere fact that the state compensation mechanism is collected from CRES providers does not alter the analysis. Moreover, AEP Ohio’s logic implies that it is reasonable to charge discriminatory prices to identical customers for the same service, which is economically inefficient, anticompetitive, and contrary to state law and policy.<sup>195</sup>

As shown by AEP Ohio’s Corporate Separation Plan, AEP Ohio admits it can no longer recover stranded costs.<sup>196</sup> Instead, all such costs must be recovered in the market and there is no basis for AEP Ohio charging an embedded capacity cost to any of its customers.<sup>197</sup> Second, AEP Generation Resources should only be able to charge AEP Ohio the market price of capacity.<sup>198</sup> Because AEP Generation Resources will operate independently of AEP Ohio, there is no rational economic basis as to why AEP Ohio would agree to purchase capacity from AEP Generation Resources at an above-market price if it can purchase that capacity at a lower price in the market.<sup>199</sup> In other words, buying capacity from AEP Generation Resources at an above-market price would be a cross-subsidy and a form of price discrimination.<sup>200</sup>

**b. Dr. Pearce inappropriately included stranded costs in his capacity cost calculation.**

Dr. Pearce’s formula rate includes no adjustment mechanism to remove stranded costs from his capacity cost calculation. This is inappropriate because S.B. 3 provided a clear

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<sup>194</sup> Lesser Direct, pp. 14-15.

<sup>195</sup> Lesser Direct, p. 15.

<sup>196</sup> 2012 Corporate Separation Plan, p. 7.

<sup>197</sup> Lesser Direct, p. 15.

<sup>198</sup> Lesser Direct, p. 15.

<sup>199</sup> Lesser Direct, p. 15.

<sup>200</sup> Lesser Direct, p. 15.

demarcation date between pre-transition and post-transition generation costs. Any cost-based capacity charges levied by AEP Ohio could apply only: (1) to generating plant that was in-service on or before December 31, 2000, the day before the transition date of January 1, 2001; and (2) if AEP Ohio had not waived recovery and/or already fully recovered these costs.<sup>201</sup>

**i. The transition period for recovering stranded generation costs is over, and AEP Ohio is not entitled to cost-based recovery of generation costs.**

AEP Ohio is barred from recovering stranded – i.e., above-market – costs through a second “transition to market.”

In the transition plan proceeding filed by CSP and OPCo in 1999, the two companies estimated stranded costs of between \$894 million and \$953 million.<sup>202</sup> AEP Ohio sought to recover these costs through a lost revenue charge imposed on shopping customers calculated using FERC formula costs,<sup>203</sup> which is the same approach used in this proceeding. As part of the stipulation approved by the Commission in that ETP case, CSP and OPCo waived the recovery of stranded generation costs through a lost revenue charge imposed on shopping customers and instead agreed to recover any such costs through market pricing.<sup>204</sup> CSP and OPCo further agreed that their only opportunity to recover RTCs would be limited to \$616 million, which CSP would recover over eight years and OPCo would recover over seven years, and that this was sufficient to recover all stranded generation-related regulatory assets.<sup>205</sup> Therefore, AEP Ohio’s

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<sup>201</sup> Lesser Direct, p. 11.

<sup>202</sup> Lesser Direct, p. 40.

<sup>203</sup> Tr. Vol. I, pp. 53-54; FES Ex. 107.

<sup>204</sup> ETP Proceeding, Opinion and Order (Sept. 28, 2000) at pp. 15-16, 18; ETP Proceeding, Stipulation (May 8, 2000) at pp. 3, 10; *see also* Lesser Direct, p. 40.

<sup>205</sup> ETP Proceeding, Opinion and Order (Sept. 28, 2000) at pp. 15-16, 18; ETP Proceeding, Stipulation (May 8, 2000) at pp. 3, 10.

attempt to receive from ratepayers above market charges is in violation of Ohio law and of AEP Ohio's own agreements.

**ii. AEP Ohio has already recovered its stranded generation-related costs.**

AEP Ohio already has recovered its stranded generation-related costs. As was done by AEP Ohio in the ETP Proceeding, Dr. Lesser relied on AEP Ohio's estimates of the stranded cost estimates of AEP Ohio witness Landon to determine the stranded costs of AEP Ohio as of December 31, 2000. AEP Ohio's highest estimate of stranded costs was \$953.1 million.<sup>206</sup> As Dr. Lesser demonstrated, because AEP Ohio had already depreciated almost \$1.43 billion in costs between December 31, 2000 and December 31, 2010, AEP Ohio already has fully recovered its stranded generation costs.<sup>207</sup> The depreciation accruals have eliminated from AEP Ohio's books the stranded costs estimated by Mr. Landon, leaving only costs that are "un-stranded" and, thus, must be recovered through competitive markets at market pricing.<sup>208</sup>

**iii. AEP Ohio's capacity cost calculation ignores S.B. 3 and inappropriately includes costs incurred after December 31, 2000.**

As explained above, under S.B. 3 all generation plant investment after January 1, 2001 was to be recovered solely in the market.<sup>209</sup> Despite this clear statutory standard, AEP Ohio's capacity cost calculation includes investments made after December 31, 2000.<sup>210</sup>

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<sup>206</sup> Lesser Direct, p. 40.

<sup>207</sup> Lesser Direct, p. 40.

<sup>208</sup> Lesser Direct, p. 40.

<sup>209</sup> R.C. §§ 4928.01(A)(28); 4928.03; 4928.06; 4928.31; 4928.38-40.

<sup>210</sup> Lesser Direct, p. 55.

**iv. AEP Ohio's capacity cost calculation seeks to recover "costs" after January 1, 2014 for assets it will no longer own.**

AEP Ohio's formula rate proposal seeks to determine the "cost" of AEP Ohio's capacity based on FERC Form 1 data. Despite its plan to transfer all of its generation assets (and accompanying costs) to AEP Generation Resources on January 1, 2014, AEP Ohio seeks to recover the "costs" of assets it will not even own for the 2013/14 and 2014/15 Planning Years.<sup>211</sup> This is absurd. It cannot be in the interests of Ohio customers to pay for the "costs" associated with assets no longer owned by AEP Ohio and that have been transferred to a competitive affiliate.

**4. Dr. Pearce's Calculation Is Incorrect Because AEP Ohio's Formula Rate Fails To Include An Offset For Energy-Related Sales.**

Dr. Pearce's rate double-recovers for capacity costs by failing to include the contributions to embedded capacity costs from energy-related sales for resale.<sup>212</sup> Dr. Pearce's formula would inappropriately permit AEP Ohio to keep all profits from such sales, and would lead to an inappropriate double-recovery for AEP Ohio. When a customer shops, AEP Ohio is then free to sell the energy freed up from that capacity resource.<sup>213</sup> An energy credit is thus necessary and appropriate since AEP Ohio recovers a portion of its fixed costs through those sales.

In its formula rate estimates of 2010 capacity costs, Dr. Pearce subtracted out only those revenues from capacity-specific sales for resale.<sup>214</sup> Dr. Pearce ignored the fact that AEP Ohio also recovers a portion of its fixed costs when it makes energy-related sales for resale because revenues received from those sales that exceed AEP Ohio's variable O&M plus fuel costs

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<sup>211</sup> Tr. Vol. II, pp. 277-80.

<sup>212</sup> Lesser Direct, p. 45.

<sup>213</sup> Tr. Vol. II, pp. 238-42.

<sup>214</sup> Lesser Direct, p. 45.

recover a portion of its embedded capacity costs.<sup>215</sup> Dr. Pearce ignored the fact that AEP Ohio's profits from energy-related sales helps recover those embedded costs and provides an additional return on embedded rate base.<sup>216</sup> Thus, AEP Ohio recovers a portion of its embedded costs twice: first, through its embedded capacity cost and second through off-system energy sales.<sup>217</sup> AEP Ohio is clearly not allowed to double recover those costs, which would be incompatible with basic rate regulation.<sup>218</sup> The correct approach, which was not followed by Dr. Pearce, would be to subtract all revenues from sales for resale that contribute to the recovery of embedded generation capacity costs.<sup>219</sup>

**a. AEP Ohio should include an offset for off-system sales.**

AEP Ohio's energy credit includes a downward adjustment of 60 percent to reflect that a majority of energy revenues associated with AEP Ohio's generating facilities is shared, or "MLR'd", with other members of the AEP East Pool.<sup>220</sup> There is no sound basis for not attributing 100% of these revenues to AEP Ohio, however. All of AEP Ohio's off-system sales revenues should be included as a credit against capacity costs. AEP Ohio is proposing to recover its embedded capacity costs from shopping customers in Ohio, while also recovering some portion of those embedded costs from off-system energy sales.<sup>221</sup> Not only would this mean

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<sup>215</sup> Lesser Direct, p. 45.

<sup>216</sup> Lesser Direct, p. 45.

<sup>217</sup> Lesser Direct, p. 46.

<sup>218</sup> Lesser Direct, p. 46.

<sup>219</sup> Lesser Direct, p. 46.

<sup>220</sup> Pearce Direct, pp. 17-18.

<sup>221</sup> Lesser Direct, p. 47.

AEP Ohio would earn more than the 11.15% return on equity it proposes in its formula rate, it violates the basic *quid pro quo* associated with embedded cost pricing that AEP Ohio seeks.<sup>222</sup>

AEP Ohio's claim of "prejudice" from the Pool Agreement should also be rejected as a matter of form over substance. The Pool Agreement can be modified by its members upon 90 days notice.<sup>223</sup> AEP Ohio witness Munczinski testified that there have been 8 or 9 modifications to the Pool Agreement since its inception.<sup>224</sup> Despite the demonstrated ability to seek changes to the Pool Agreement, AEP Ohio has not requested a modification of the Pool Agreement to take into account the effect of retail shopping.<sup>225</sup> It is improper for AEP Ohio to claim to be significantly prejudiced by an agreement it entered into with other AEP entities and which it has not sought to change (but it has the ability to change), especially when other changes have been made. Instead, AEP Ohio is asking shopping customers, who have no ability to seek changes to the Pool Agreement, to pay for any impact on AEP Ohio. This is neither fair nor equitable, and at minimum AEP Ohio must demonstrate that it took reasonable steps with other AEP entities to resolve this issue before seeking to impose charges on CRES providers and Ohio customers who are captive to AEP's capacity. As AEP Ohio did not do this, AEP Ohio's claim of prejudice from the Pool Agreement should be rejected. All energy revenue from off-system sales should be attributed to AEP Ohio.

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<sup>222</sup> Lesser Direct, p. 47.

<sup>223</sup> Tr. Vol. I, pp. 29-30.

<sup>224</sup> Tr. Vol. I, p. 29.

<sup>225</sup> Tr. Vol. I, p. 30.

At minimum, AEP Ohio should account for off-system sale revenue in its capacity price, and at minimum should account for its portion after Pool sharing of the off-system sales revenue, or \$1,073,332,384.<sup>226</sup>

**b. No pool adjustment is necessary during the Bridge Period, because the Pool members have already given notice that they are terminating the Pool.**

AEP Ohio and the other pool members have already given notice that the Pool would terminate as of January 1, 2014.<sup>227</sup> As AEP Ohio's profits from off-system sales will not be shared during the Bridge Period between January 1, 2014 and May 31, 2015,<sup>228</sup> there is no reason to include any reduction to the off-system sales revenue due to the operation of the Pool after January 1, 2014.

**c. An energy credit is necessary to avoid an above-market return on equity for AEP Ohio.**

If AEP Ohio did not sell any of the energy generated by its generating resources, and only sold capacity, the \$355.72/MW-day rate would provide AEP Ohio with an allowed 11.15% return on equity.<sup>229</sup> By also retaining all or a portion of the profits from energy sales, AEP Ohio's realized return on equity will be higher than the 11.15% allowed return in the formula rate.<sup>230</sup> This is problematic, because it guarantees AEP Ohio an above-market return. If AEP Ohio's total after tax return would ordinarily be \$440.4 million at 11.15%, and it is also allowed to keep a net \$108.6 million (after expenses and taxes) in off-system energy sales, then AEP

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<sup>226</sup> Lesser Direct, pp. 48-49.

<sup>227</sup> Tr. Vol. I, p. 31; Lesser Direct, p. 46.

<sup>228</sup> Tr. Vol. I, p. 32.

<sup>229</sup> Lesser Direct, p. 49.

<sup>230</sup> Lesser Direct, p. 49.



Ohio will earn \$549 million.<sup>231</sup> This implies an overall return on equity of 15.13%, which is much higher than the risk-comparable return of 11.15% suggested by AEP Ohio.<sup>232</sup>

**d. AEP Ohio's opposition to the energy credit lacks merit.**

AEP Ohio has opposed an energy credit, arguing that energy and capacity have been separated by PJM and that the FRR election does not provide a call option on energy for Ohio customers.<sup>233</sup> AEP Ohio is wrong.

AEP Ohio first proposes that the energy credit be limited to only those revenues received by AEP Ohio after the operation of the Pool Agreement.<sup>234</sup> As discussed above, the energy credit should not be limited by the Pool Agreement since AEP Ohio voluntarily entered into this agreement, has not sought to modify the agreement to account for shopping, which has been going on for years, and has agreed with the other AEP entities to terminate the agreement as of January 1, 2014. Moreover, it hardly seems equitable to deny Ohio customers the benefit of off-system sales under the Pool Agreement when Appalachian Power customers in West Virginia are credited with 100% of the proceeds of those sales – despite the fact that Appalachian Power is short on capacity and AEP Ohio is long.<sup>235</sup>

AEP Ohio has also suggested that, if any energy credit is adopted, it should be reduced by 50% to reflect the margin sharing percentage used above the base in the FERC template for Prescott and Minden.<sup>236</sup> This 50% energy margin would go to AEP Ohio's shareholders.<sup>237</sup> There is no justification for this distinction.

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<sup>231</sup> Lesser Direct, p. 50.

<sup>232</sup> Lesser Direct, p. 50.

<sup>233</sup> Pearce Direct, p. 13.

<sup>234</sup> Tr. Vol. II, p. 266.

<sup>235</sup> Tr. Vol. II, pp. 275-76.

<sup>236</sup> Pearce Direct, p. 18.

Similarly, AEP Ohio has proposed that the energy credit “should further be capped at 40% of the capacity charge that would be applicable with no energy credit.”<sup>238</sup> AEP Ohio offers no justification for this charge, other than to claim that without this charge the energy credit “could get so large as to greatly reduce any capacity payment whatsoever from CRES providers.”<sup>239</sup> This argument shows the gamesmanship performed by AEP Ohio in this case.<sup>240</sup> AEP Ohio wants guaranteed cost recovery, regardless of whether or not these revenues are necessary for AEP Ohio to operate. In times of high energy prices, AEP Ohio will be receiving correspondingly high revenues from its generating resources. AEP Ohio wants this to result in a windfall to AEP Ohio, rather than to appropriately adjust the cost-based pricing mechanism which it proposes in this proceeding. This type of behavior should be rejected by the Commission.

**e. If the Commission does not require AEP Ohio to charge the PJM market price, then Dr. Lesser’s cost-based approach, including his energy credit, should be adopted.**

Dr. Lesser’s proposed energy credit is extremely favorable to AEP Ohio. Dr. Lesser simply used the FERC account information for AEP Ohio, without adjusting this information upward to reflect the sharing of revenue under the Pool or the termination of the Pool on January 1, 2014. Specifically, even with a calculation which adjusts for fuel and allows AEP Ohio to share its off system sale revenue with other members of the Pool, both before and after the termination of the Pool, Dr. Lesser found that AEP Ohio overstated its capacity costs by \$178.1 million by failing to include an offset for energy sales.

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<sup>237</sup> Tr. Vol. II, pp. 265-66.

<sup>238</sup> Pearce Direct, p. 18.

<sup>239</sup> Pearce Direct, p. 18.

<sup>240</sup> Stoddard Direct, pp. 38–39.

In rebuttal testimony, AEP Ohio challenged Dr. Lesser's cost-based capacity calculation by arguing that Dr. Lesser should have reduced the capacity revenue received by AEP Ohio to account for post-2000 investment that is not recoverable under Ohio law.<sup>241</sup> Dr. Lesser removed the post-2000 costs because S.B. 3 required that AEP Ohio's generation compete in the competitive market. Nothing in S.B. 221 changed this express requirement. Removal of post-2000 costs from the calculation does not mean that the associated capacity does not exist, but only that, under Ohio law, those costs are recoverable solely from the competitive market. Thus, the energy margins that AEP Ohio will receive should not be adjusted to account for the removal of stranded costs for two reasons. First, AEP Ohio already has recovered its stranded costs and environmental compliance costs through the EICCR.<sup>242</sup> This means that AEP Ohio is seeking to recover for the same environmental compliance costs twice: once through the EICCR and once through a capacity charge.<sup>243</sup> This double recovery violates basic ratemaking principles, and is simply a further illustration of the overreaching nature of AEP Ohio's calculation. Second, AEP Ohio admitted that production does not track depreciation.<sup>244</sup> There is no reason to decrease the capacity sale offset showing the revenue which AEP Ohio actually receives simply because certain costs are stranded under Ohio law. AEP Ohio already has recovered for these investments from Ohio customers. As AEP Ohio has recovered these costs, there is no reason to decrease Dr. Lesser's calculated capacity cost in the manner suggested by AEP Ohio witness Nelson.

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<sup>241</sup> AEP Ohio Ex. 143, Rebuttal Testimony of Philip J. Nelson, filed May 11, 2012 ("Nelson Rebuttal"), p. 4.

<sup>242</sup> Tr. Vol. XII, p. 2621; Lesser Direct, p. 44.

<sup>243</sup> Lesser Direct, p. 44.

<sup>244</sup> Tr. Vol. XII, pp. 2616-22.

## 5. AEP Ohio's Full Embedded Capacity Cost Is \$78.53/MW-day Or, At Most, \$91/MW-day.

If the Commission does consider full embedded cost, despite being contrary to the PJM structure and encouraging uneconomic decision making, then Dr. Lesser's analysis is the most probative. As he explains, after the appropriate adjustments to reflect the removal of: (1) stranded costs; (2) post-2001 investment; and (3) the minimum appropriate energy offset, AEP Ohio's true cost of capacity is \$78.53/MW-day.

If a further adjustment is made to credit back to AEP Ohio the capacity equalization payments made possible by the two plants acquired by AEP Ohio in 2005 and 2007 – Waterford and Darby – the capacity cost would increase to approximately \$91/MW-day. These two plants have a combined seasonal total capacity of 1,248 MWs, which is approximately 10.1% of the total seasonal capacity for AEP Ohio's pre-2001 owned and contracted facilities of 12,321.<sup>245</sup> As such, 10.1% of the \$401,432,492 in capacity equalization payments identified by AEP Ohio witness Nelson<sup>246</sup> results in a credit back of \$40,661,289. The resulting flow-through of this adjustment to Dr. Lesser's calculation is shown below:

Lesser's Revised Calculation w/ Nelson Pool Adjustments	
Item	TOTAL
Annual Production Fixed Cost, as Reported	\$ 1,137,598,132.00
(Energy-only contribution to embedded costs s adjustment)	\$ (178,077,466.00)
<u>Adjustment for Darby/Waterford Capacity Equalization Payments</u>	\$ 40,661,289.00
Calculated Depreciation Rate Adjustment	\$ (173,529,676.00)
Calculated Return on Rate Base Adjustment	\$ (379,994,176.00)
Calculated Income Tax Adjustment	\$ (146,272,028.00)
Total Adjustments to Annual Production Cost, as Reported	\$ (837,212,057.00)
Revised Annual Production Costs	\$ 300,386,075.00

<sup>245</sup> FES Ex. 126. The total capacity shown is 13,606, from which Conesville 3 is deducted because it is scheduled for retirement by the end of 2012 and the Lawrenceburg units under contract to CSP are deducted because they were acquired after January 1, 2001. These capacity values can vary slightly depending on the data source used.

<sup>246</sup> Nelson Rebuttal, p. 4.

5 CP Coincident Peak Demand (MW)	\$	9,060.80
Revised Daily Capacity Cost (\$/MW-day)	\$	90.83

### **C. AEP Ohio’s Proposed Capacity Pricing Would Preclude Customers From Receiving The Benefits Of Competition.**

#### **1. Competition Is State Law And Policy, And Benefits Customers**

“Competition is the best way to promote lower generation prices for customers, to promote greater productivity and efficiencies from the numerous existing generating plants, to reduce the risk imposed on customers, and to provide the appropriate market signals regarding the need for new generation.”<sup>247</sup> Therefore, it is not surprising that the General Assembly established a competitive market for retail electric generation service in Ohio<sup>248</sup> and supported that law with numerous state policies that seek to promote various aspects of a well-functioning competitive market, as discussed briefly above.<sup>249</sup> The General Assembly has directed the Commission to effectuate these policies.<sup>250</sup> The Commission also is required to “monitor and evaluate the provision of retail electric service in this state. . . for the purpose of discerning any competitive retail electric service that is no longer subject to effective competition” and to “exercise [its] authority, to resolve abuses of market power by any electric utility that interfere with effective competition in the provision of retail electric service.”<sup>251</sup>

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<sup>247</sup> FES Ex. 102, Direct Testimony of Tony C. Banks, filed Apr. 4, 2012 (“Banks Direct”), p. 4.

<sup>248</sup> R.C. § 4928.03.

<sup>249</sup> R.C. § 4928.02 (“It is the policy of this state to: . . . (B) Ensure the availability of unbundled and comparable retail electric service . . . ; (C) Ensure diversity of electricity supplies and suppliers . . . ; (G) Recognize the continuing emergence of competitive electricity markets through the development and implementation of flexible regulatory treatment; (H) Ensure effective competition in the provision of retail electric service by avoiding anticompetitive subsidies . . . ; [and] (I) Ensure retail electric service consumers protection against unreasonable sales practices, market deficiencies, and market power . . .”).

<sup>250</sup> R.C. § 4928.06(A) (“Beginning on the starting date of competitive retail electric service, the public utilities commission shall ensure that the policy specified in section 4928.02 of the Revised Code is effectuated.”).

<sup>251</sup> R.C. § 4928.06(A), (C), (E)(1).

It is well-established and accepted by all parties that competition benefits customers. Indeed, no witness challenged the benefits that competition brings to customers. For example, AEP Ohio witness Graves agreed that competition puts downward pressure on margins.<sup>252</sup> As FES witness Banks explained:

A competitive market encourages electric suppliers to reduce their costs in order to earn the ability to serve more customers. These cost reductions may come from reduced supplier profits or increased operating efficiencies. The cost reductions are then reflected in lower prices that are enjoyed by all customers. . . .

Ohio customers are taking advantage of these savings opportunities – over 1.7 million Ohio customers have chosen to shop for retail electric service while paying market-based capacity prices without harming the utilities that provide their distribution service. In the FirstEnergy Ohio utilities’ service territory alone, shopping customers have saved over \$100 million annually based on a conservative estimate of a 4% average discount provided by CRES providers.<sup>253</sup>

AEP Ohio’s competitive affiliate, AEP Retail, actually has furthered the savings provided in Mr. Banks’ conservative example, illustrating the beneficial effects of CRES providers competing against each other. AEP Retail has recently offered 24% off the price-to-compare in the FirstEnergy Ohio utilities’ territories, where AEP Retail has access to RPM-priced capacity and it is thus able to offer 5.69 cents per kWh.<sup>254</sup>

AEP Retail’s offer in the FirstEnergy Ohio utilities’ territories reflects the benefits of competition, as well as the anti-competitive nature of AEP Ohio’s position in this case. When operating in other territories where RPM-priced capacity is available, AEP Ohio’s affiliate offers rates that are well below what AEP Ohio claims are the costs of service for its SSO customers:

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<sup>252</sup> Tr. Vol. V, pp. 864-865.

<sup>253</sup> Banks Direct, pp. 4-5.

<sup>254</sup> Tr. Vol. VIII, p. 1662-1663.

**AEP Retail Offer in FE Service Territory**  
**(¢/kWh)<sup>255</sup> 5.69**

<u>AEP Ohio Purported Cost to Serve (¢/kWh)</u>	<u>CSP</u>	<u>OP</u>
Capacity @ \$355/MW-day <sup>256</sup>	2.8170	2.8170
Fuel Cost (Rider FAC) <sup>257</sup>	4.0504	3.4436
Ancillary Services <sup>258</sup>	0.0600	0.0600
Non-Fuel Energy Costs <sup>259</sup>	0.3255	0.3255
Subtotal <sup>260</sup>	7.2529	6.6461

Thus, when operating in other territories, AEP Retail uses competitive markets and market-based pricing to gain market share. While operating in its own service territory, AEP Ohio attempts to stop competition by demanding above-market pricing for its capacity.

The testimony offered in this proceeding further confirmed the benefits that competition brings to customers. For example, a coalition of school entities “decided to join forces and work to cooperatively reduce” their electricity costs, eventually negotiating with various suppliers.<sup>261</sup> As a result, the participants in the Power4Schools program have saved an estimated \$20 million on their electricity costs.<sup>262</sup> The Lima Refining Company testified that to mitigate its significant costs for electricity, Lima Refining “shopped the generation portion of our electric bills in recent years to take advantage of the attractive market rates in order to continue to be competitive in our

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<sup>255</sup> FES Ex. 120.

<sup>256</sup> Lesser Direct, p. 21.

<sup>257</sup> Rider FAC as of April 1, 2012.

<sup>258</sup> Lesser Direct, p. 21.

<sup>259</sup> Lesser Direct, p. 54. Average rate for based on FERC accounts 510, 512, 513, and 544 divided by total production sales from the 2010 FERC Form 1. Exhibit KDP-3 in Pearce's testimony in Case No. 10-2929-EL-UNC acknowledges these accounts as energy related and they are not listed as being included in Rider FAC in Nelson's testimony Case No. 11-346-EL-SSO (pp. 14-16 filed 3.30.12).

<sup>260</sup> This subtotal is conservative as it does not include any market-based transmission costs associated with serving these customers.

<sup>261</sup> Tr. Vol. IX, p. 1759.

<sup>262</sup> See Frye Direct, pp. 3-4; Tr. Vol. IX, p. 1759.

market sector.”<sup>263</sup> Other manufacturing customers, including OSCO Industries and Whirlpool Corporation, testified similarly.<sup>264</sup> Thus, it is clear that the state’s competitive market for retail electric generation service benefits customers.

## **2. The Proposed \$355.72/MW-day Price Would Harm Competition And Customers.**

Whereas AEP Ohio consistently has charged RPM-based prices for capacity from June 1, 2007 through the end of December 2011,<sup>265</sup> it now seeks to impose a \$355/MW-day price for the capacity provided to shopping customers, a price four times higher than the average RPM-based prices over the next three years.<sup>266</sup> This significant increase would constrain shopping and disrupt the competitive market in AEP Ohio’s service territory<sup>267</sup> -- an area that is just beginning to enjoy the benefits of the competition that flourishes elsewhere in the state.

### **a. Increasing capacity prices four times higher than RPM prices would eliminate headroom and the savings promoted by competition.**

AEP Ohio witness Allen acknowledged that as capacity charges increase, the headroom available for CRES providers to offer savings decreases.<sup>268</sup> AEP Ohio witness Graves also agreed that if the state compensation mechanism was set at RPM-based prices, there would be

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<sup>263</sup> OMA Ex. 103-A, Direct Testimony of Lima Refining Company, filed Apr. 4, 2012 (“Lima Refining Direct”), p. 3.

<sup>264</sup> OMA Ex. 104-A, Direct Testimony of OSCO Industries, Inc., filed Apr. 4, 2012 (“OSCO Industries Direct”), p. 3; OMA Ex. 102-A, Direct Testimony of the Whirlpool Corporation, filed Apr. 4, 2012 (“Whirlpool Direct”), p. 3; OMA Ex. 101-A, Direct Testimony of AMG Vanadium Inc., filed Apr. 4, 2012 (“AMG Vanadium Direct”), p. 3.

<sup>265</sup> Tr. Vol. I, p. 89.

<sup>266</sup> Lesser Direct, p. 3.

<sup>267</sup> “[AEP Ohio’s] proposal in this case to set a capacity rate at \$355 per megawatt day will have a negative effect on the continuing development of competition and will be -- not lead to continuing development of competition in the AEP service territory as I believe the statute directs.” Tr. Vol. VIII, p. 1526 (Constellation witness Fein).

<sup>268</sup> Tr. Vol. III, p. 712.



more CRES providers serving customers than if the Commission adopted AEP Ohio's cost-based proposal.<sup>269</sup> CRES provider witnesses confirmed that CRES providers cannot offer savings to customers if capacity is priced at \$355/MW-day.<sup>270</sup> As a result, if capacity costs increase to \$355, IGS witness Hamman testified, "[g]oing forward that would have a drastic impact on the . . . competitive market. The pricing would have to take that higher cost into effect and we would pass through to the rates that customers would be shown in the market."<sup>271</sup> The capacity prices imposed by AEP Ohio would necessarily be incorporated in CRES prices. FES witness Banks explained:

[T]here are various component costs that go[] into a price that FES might offer a customer. You have to pay for your energy costs. You have to pay for a swing in a customer load, basically your load profile. You have to pay for capacity. You have to pay for any risk adders you think are appropriate in the deal, and you also have to pay for your administrative costs of being a retail company. On top of that you may add a margin, that's what retailers do in the market. They offer costs plus whatever is their margin, so capacity is a cost that indirectly the customer ends up paying the CRES provider for.<sup>272</sup>

RESA witness Ringenbach further explained that, "[i]f AEP is granted their request to receive \$355/MW-day for capacity, all shopping customers, including schools, small commercial

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<sup>269</sup> Tr. Vol. V, pp. 862-863.

<sup>270</sup> Tr. Vol. VIII (Fein), p. 1564; IGS Ex. 101, Direct Testimony of Raymond Hamman, filed Apr. 4, 2012 ("Hamman Direct"), p. 5 (If CRES providers were required to pay above-market capacity prices, "CRES suppliers would have to charge higher rates for service or be prevented from entering the market altogether."); *see also* OEG Ex. 101, Direct Testimony of Roger R. Geiger, filed Apr. 4, 2012 ("Geiger Direct"), p. 5 (even at \$255/MW-day, competition would be harmed).

<sup>271</sup> Tr. Vol. IV, p. 784 (IGS witness Hamman); *see also* Frye Direct, p. 9 (approving the \$355/MW-day capacity price could cause CRES providers to trigger the "regulatory provision" contained in many contracts, which would pass through the increased costs to customers).

<sup>272</sup> Tr. Vol. VIII, p. 1693.

customers, and those in governmental aggregation, would see an immediate increase in their electric bills and may be forced to break their contract with the CRES.”<sup>273</sup>

The same increases in prices and potential turmoil in the status of CRES contracts would, indeed, exist with governmental aggregation contracts, as well.<sup>274</sup> Governmental aggregation is “one of the most significant mechanisms for residential and smaller commercial customers to shop.”<sup>275</sup> A number of communities in AEP Ohio’s territory recently have instituted governmental aggregation programs to try to access savings through the competitive market -- 20 communities have completed the process and 60 other communities have started.<sup>276</sup> However, as explained by FES witness Banks, “community officials may be forced to go back and explain that the benefits of governmental aggregation – and the significant savings to customers – may not be realized as anticipated because AEP Ohio was authorized to charge a capacity price that is multiple times higher than RPM market-based prices.”<sup>277</sup> As a result, Commission approval of above-market capacity prices for shopping customers would be inconsistent with the Commission’s statutory charge to institute rules that “encourage and promote large-scale governmental aggregation in this state.”<sup>278</sup>

AEP Ohio may suggest that CRES providers will unfairly pass-through the increased capacity cost to customers. First, of course, it is not CRES providers that have asked to recover a price for capacity that is four times higher than the RPM-based price; AEP Ohio is responsible

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<sup>273</sup> RESA Ex. 101, Direct Testimony of Teresa L. Ringenbach, filed Apr. 4, 2012 (“Ringenbach Direct”), p. 19.

<sup>274</sup> See Banks Direct, pp. 9-10.

<sup>275</sup> Banks Direct, p. 9.

<sup>276</sup> Banks Direct, p. 9.

<sup>277</sup> Banks Direct, p. 10.

<sup>278</sup> R.C. § 4928.20(K).

for that increase in costs. Second, the pass-through provisions found in many CRES contracts should not, in the ordinary course, raise any concerns: “Because you have to understand that the pass-through event that is contemplated here [in a CRES contract] is an event that would result in additional capacity charges or transmission charges that FES may incur, but that may also incur on the side of the utility. So the impact on the PTC or the savings from the PTC don’t change” in the usual case.<sup>279</sup> Here, AEP Ohio’s requested significant increase in capacity pricing is problematic because it is applicable only to shopping customers.<sup>280</sup> In addition, to the extent customers may face burdensome increases in price as compared to the SSO rates due to the pass-through, customers also may have the ability to terminate the CRES contracts. For example, “[i]n this proceeding if we were required to pay a capacity charge, then FES would always honor its contracts, but in this case [if capacity was priced at \$355/MW-day] we would lose money. That’s why later on we decided to try to cover ourselves for those circumstances . . . and that’s why we started developing language around both parties being able to get out of the contract.”<sup>281</sup>

To the extent AEP Ohio suggests that CRES providers may keep any “discount” or reduced capacity pricing, rather than pass it along to customers, this suggestion reflects an ignorance of the incentives established by the competitive market and was rejected by FES witness Banks:

[I]f you really have been in the competitive markets, you learn to understand that any price that a CRES provider offers, to the extent

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<sup>279</sup> Tr. Vol. VIII, p. 1686.

<sup>280</sup> See Ringenbach Direct, p. 12 (“AEP Ohio’s request [for \$355/MW-day] harms the development of a robust retail market for competitive service not only because it assesses shopping customers a non-transparent capacity price, but AEP Ohio is effectively diminishing the advantages of shopping by raising capacity costs only for shopping customers.”).

<sup>281</sup> Tr. Vol. VIII, p. 1688. Mr. Banks further explained that: “The customer knows that [FES has the right to terminate its contracts], and we went into the contract with that understanding with the customer.” Tr. Vol. VIII, p. 1705-1706.

there's competition, it's subject to competition from other suppliers.

So if a CRES provider got a discount on anything that was readily available in the marketplace, the CRES provider is going to have to pass those savings on to customers; otherwise, they risk losing those customers.<sup>282</sup>

This suggestion was also rejected by RESA witness Ringenbach, who testified that CRES providers will compete amongst themselves to ensure the AEP Ohio's customers receive the benefit of market-based capacity pricing.<sup>283</sup> AEP Ohio's Proposed Capacity Pricing should be rejected so that AEP Ohio's customers can receive savings available in the competitive marketplace.

**b. AEP Ohio's capacity pricing has caused confusion in the market, to the detriment of competition and AEP Ohio's customers.**

The various uncertainties associated with AEP Ohio's capacity pricing permeate the market for electric generation service in its territory. First, the price of capacity for SSO customers is unknown. The fact that AEP Ohio's capacity prices to SSO customers are unknown and un-itemized means that there is no basis of comparison to CRES pricing: "AEP Ohio's tariff prices do not have a discrete capacity price component or a discrete energy price component. As a result, a small commercial customer cannot look at the Commission's Apples to Apples chart and determine whether a competitive offer for energy is more or less than the tariff rate for energy."<sup>284</sup> Second, the price of capacity for shopping customers in AEP Ohio's service territory has been uncertain for over a year and a half. "[F]rom a supplier and customer perspective, [that uncertainty] causes a lot of confusion, and as a result, acts as a damper on competitive

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<sup>282</sup> Tr. Vol. VIII, pp. 1660-1661.

<sup>283</sup> Tr. Vol. pp. 836-37.

<sup>284</sup> Ringenbach Direct, p. 13.

markets.”<sup>285</sup> Thus, the uncertainty has affected customers who are already shopping and those that may consider shopping in the future.<sup>286</sup> CRES contracts that assumed an RPM-based capacity price (or another price lower than the proposed \$355/MW-day price) could all of a sudden become uneconomical.<sup>287</sup>

A fixed \$355/MW-day capacity price would not remedy the uncertainty, as may be argued by AEP Ohio. It does nothing to resolve the uncertainty associated with SSO customers’ capacity pricing and customers’ ability to compare market offers. It also does not resolve the negative impact of the uncertainty associated with shopping customers’ capacity pricing. Whether the capacity price is fixed at some number is not the issue. Rather, providers need to know in advance what the prices for capacity will be -- as provided by RPM prices that are established for the next three years.<sup>288</sup>

[The] swings [in RPM pricing] were known. It was known by the entire market that the capacity cost of a shopping customer that would be charged to a CRES provider was going to be those numbers . . . . All of a sudden now the capacity charge is asked to be different midstream based on the stip[ulation] that was filed in September, and then asked to be different again in this capacity case, then asked to be different again in the modified ESP. So that’s the problem. Nobody knows what is going to happen.<sup>289</sup>

As Dr. Lesser recommended, if the Commission approves some above-market capacity price for shopping customers’ capacity, the Commission should require AEP Ohio to unbundle its base generation rate into energy and capacity components. An unbundled base generation

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<sup>285</sup> Tr. Vol. VIII, p. 1702.

<sup>286</sup> See OMA Ex. 105-A, Direct Testimony of the Belden Brick Company, LLC, filed Apr. 4, 2012 (“Belden Brick Direct”), p. 4; Geiger Direct, p. 5.

<sup>287</sup> See Tr. Vol. VIII, p. 1704.

<sup>288</sup> See Tr. Vol. VIII, p. 1529.

<sup>289</sup> Tr. Vol. VIII, p. 1703, 1702.

rate would “ensure that AEP Ohio is charging the same price” and will allow shopping customers to compare any markets available in the competitive market.<sup>290</sup>

**c. AEP Ohio’s suggestion that shopping would increase under the \$355/MW-day price is unsupported.**

AEP Ohio witness Allen points to allegedly increased shopping seen in its service territory since January 1, 2012 (when it instituted two tiers of capacity prices for shopping customers: RPM-based prices for a certain percentage and \$255/MW-day for the second tier), in an apparent effort to suggest that the proposed \$355/MW-day price would not harm shopping.<sup>291</sup> First, as FES witness Banks noted, any shopping at \$255/MW-day says nothing about what shopping is possible at the substantially higher \$355/MW-day price.<sup>292</sup> In addition, Mr. Allen acknowledges that he does not know how many of the customers who have shopped at \$255/MW-day would have expected to receive RPM-based capacity prices next year or the year after.<sup>293</sup> He also acknowledged that CRES providers had information available that would allow them to reach some conclusions as to the likelihood that such customers would received RPM-priced capacity next year or the year after.<sup>294</sup> Thus, as Mr. Banks testified, FES (and likely other CRES providers) priced its contracts assuming that the customer would, during the term of the CRES contract, receive RPM-based pricing -- either through the Commission’s resolution of this proceeding or through the Tier 1 caps temporarily instituted under the Stipulated ESP.<sup>295</sup> IGS witness Hamman concurred with Mr. Banks; when IGS entered AEP Ohio’s service territory, it

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<sup>290</sup> Lesser Direct, p. 22.

<sup>291</sup> See Allen Direct, pp. 5-6.

<sup>292</sup> Banks Direct, p. 7.

<sup>293</sup> Tr. Vol. III, p. 575.

<sup>294</sup> Tr. Vol. III, p. 576.

<sup>295</sup> Banks Direct, pp. 7-8.

had an expectation of RPM-based pricing for capacity.<sup>296</sup> Both FES and IGS, for example, also retained the right to terminate their CRES agreements if RPM-priced capacity was not made available to the customers.<sup>297</sup> Therefore, recent shopping activity in AEP Ohio's service territory is not an indicator of whether there could be shopping at the increased \$355/MW-day capacity price -- and, as set forth *supra*, there would be none.

### **3. The Proposed \$355/MW-day Price Would Provide Improper, Anti-Competitive Benefits To AEP Ohio.**

AEP Ohio is apparently a "bundled company."<sup>298</sup> As such, it has powers and opportunities not available to other CRES providers against whom it competes to provide electric generation service both in and outside of its service territory. AEP Ohio's status as a *bundled company* and its associated market power are antithetical to an effective competitive market. "[T]he distribution utility should not be viewed as a competitor. They should be viewed as indifferent to the power that flows on their lines. That attribute is a key attribute to a well functioning, competitive market."<sup>299</sup> Constellation witness Fein further explained that:

[I]n a functioning, competitive marketplace AEP Ohio and say, for example, Exelon Energy or Constellation NewEnergy would not be viewed as a competitor. We would be viewed as a competitive supplier utilizing your facilities and network as the distribution utility to provide service to end use customers and that is an attribute that is in all of the well functioning markets. And frankly that's one of the reasons why competition never really developed here in the AEP Ohio service territory because that separation never really occurred.<sup>300</sup>

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<sup>296</sup> Tr. Vol. IV, pp. 776-777 (under the previous Stipulated ESP, IGS planned to focus its sales offers on residential customers, for whom there was still room under the Stipulated ESP's caps on RPM-based capacity prices).

<sup>297</sup> Banks Direct, p. 7; Tr. Vol. IV, pp. 777-778.

<sup>298</sup> Tr. Vol. I, p. 79.

<sup>299</sup> Tr. Vol. VIII (Constellation witness Fein), pp. 1539-1540.

<sup>300</sup> Tr. Vol. VIII (Fein), pp. 1541-1542.

The option to elect FRR status, which led to the opportunity for AEP Ohio to request above-market, “fully embedded cost” recovery for the capacity needed by competitive suppliers is a significant example of AEP Ohio’s unique and unfairly favored position. If the Commission approved the \$355/MW-day price for capacity (or any other price higher than the RPM, market prices for capacity), it would provide AEP Ohio with an additional revenue stream not available to competitive suppliers. CRES providers can only receive RPM market-based prices for their capacity.<sup>301</sup> But, “there are no additional costs [for an FRR entity] that other generators in PJM are not incurring and those generators are willing to bid their capacity in the RPM and receive the revenue that is based on that pricing that is set in the auction.”<sup>302</sup> As a result, AEP Ohio would receive revenue not available to CRES providers, which would serve as a subsidy to, and competitive advantage for, AEP Ohio.<sup>303</sup> AEP Ohio witness Munczinski admitted that the above-market revenue would allow AEP Ohio to subsidize its competitive generation and non-competitive distribution services: “It will allow us to make investments in our generation plants as it will in our distribution because, again, we are a bundled company.”<sup>304</sup> He also admitted that, on the flip side, AEP Ohio’s concern regarding the use of RPM-based capacity prices is that using such prices would undermine “all” of AEP Ohio’s services, including distribution services.<sup>305</sup>

After corporate separation, the capacity for SSO and non-SSO customers would be supplied by AEP Ohio’s competitive affiliate, AEP Generation Resources, and AEP Generation

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<sup>301</sup> Banks Direct, p. 14.

<sup>302</sup> Tr. Vol. IV, pp. 786-787 (IGS witness Hamman).

<sup>303</sup> See Hamman Direct, p. 5 (To require CRES suppliers to pay any more for the market capacity would be artificially subsidizing AEP [Ohio].”).

<sup>304</sup> Tr. Vol. I, p. 79.

<sup>305</sup> Tr. Vol. I, pp. 33-35.



Resources would receive the above-market \$355/MW-day price for capacity.<sup>306</sup> At that point, the anti-competitive subsidy becomes even more apparent. As FES witness Dr. Lesser testified:

Because AEP Generation Resources will operate independently of AEP Ohio, there is no rational economic basis as to why AEP Ohio would agree to purchase capacity from AEP Generation Resources at an above-market price if it can purchase that capacity at a lower price in the market. In other words, buying capacity from AEP Generation Resources at an above-market price would be a cross-subsidy and a form of price discrimination.<sup>307</sup>

Competitive markets work best without such cross-subsidies, which are prohibited in well-functioning markets.<sup>308</sup>

In order to establish a more level playing field in AEP Ohio's service territory and promote the competitive market established by state law and policy, capacity should be priced at RPM-based prices for all customers in AEP Ohio's service territory and all customers in Ohio.

[I]f you have a company, who by virtue of its own decisions determines that it wants to be a monopoly, which AEP through the election of FRR had decided it wants to be a monopoly in its service territory, so that monopoly now has market power over all the customers in its service territory. So I believe that when you have market power, the best indication of the appropriate price that a monopoly that has market power should charge is the market-based price; otherwise, monopolies would be able to charge anything they want. . . . [I]f AEP is allowed to charge 355 per megawatt-day for capacity, the subsidy is actually from the CRES providers to AEP because AEP is the only company that would be able to get that above-market capacity value in a market that's readily able and willing to offer capacity at RPM prices.<sup>309</sup>

AEP Ohio's Proposed Capacity Pricing should be rejected because the competitive market is able and willing to offer capacity at the significantly lower RPM prices, which can provide

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<sup>306</sup> Tr. Vol. I, pp. 41-42.

<sup>307</sup> Lesser Direct, p. 15.

<sup>308</sup> Tr. Vol. VIII (Fein), pp. 1548-1549; *see also* p. 1676 (FES witness Banks agreeing with Constellation witness Fein that competitive markets work without subsidies).

<sup>309</sup> Tr. Vol. VIII, pp. 1676-1677 (Banks).

significant savings to customers while providing incentives for all generators, including AEP Ohio, to lower their costs.

#### **4. The Proposed Capacity Pricing Is Unfortunately Consistent With AEP Ohio's Resistance To Competition.**

AEP Ohio historically has charged CRES providers RPM pricing and is now seeking to change the current system for the period of January 1, 2012 through May 31, 2015. However, CRES providers no longer have the ability to make their own FRR election, or to supply their own capacity, during any part of this period and are thus trapped into paying AEP Ohio's above market price.<sup>310</sup> Now, when CRES providers are prohibited from providing their own capacity, AEP Ohio seeks to institute a "bait and switch" of capacity pricing, which will limit CRES providers' ability to offer savings to customers in AEP Ohio's service territory change the rules of the game by implementing prices which are more than four times higher than market.

AEP Ohio has, and always has had, the lowest shopping numbers in the state. Despite the gains lauded by AEP Ohio witness Allen, only ~4% of the over 1.7 million Ohio customers who were shopping as of December 2011, were located in AEP Ohio's service territory.<sup>311</sup> AEP Ohio witness Allen has testified that AEP Ohio's switch statistics have increased since December 2011 to 21.6% as of March 1, 2012, with the potential for 36.7%.<sup>312</sup> However, as

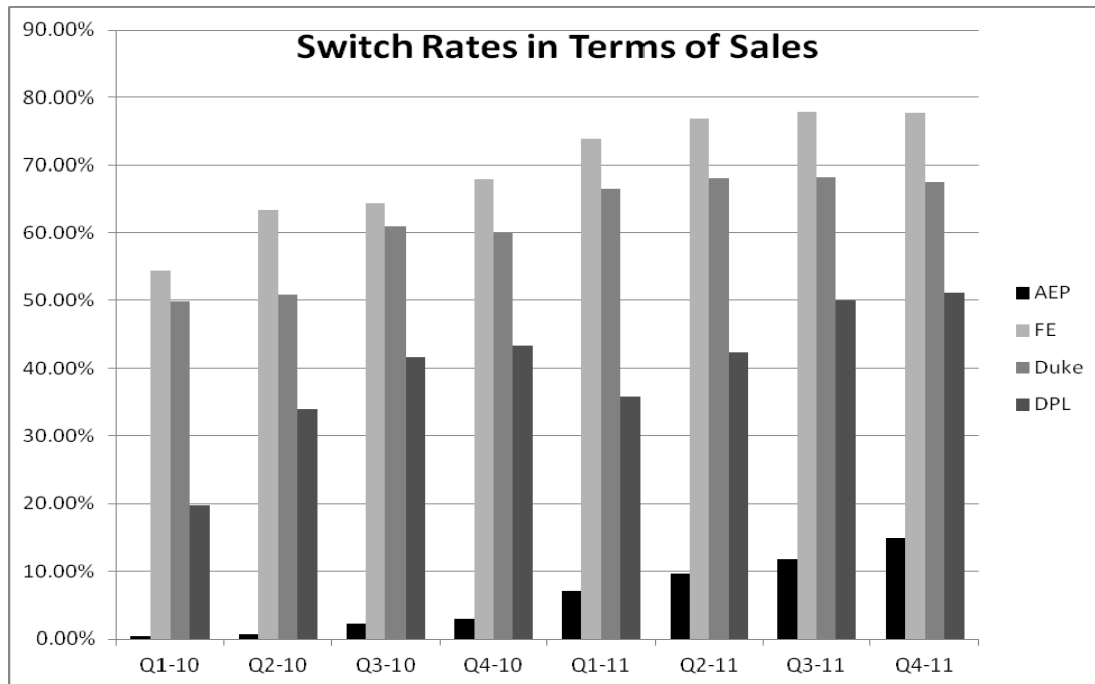
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<sup>310</sup> Stoddard Direct, pp. 42-44. CRES providers could have elected their own capacity into AEP Ohio's FRR plan for the 2014/15 Planning Year by giving notice prior to May 2011. Stoddard Direct, p. 43. Yet there was still no reason for CRES providers to make this election at that time. AEP Ohio had begun to argue a few months earlier at the FERC and in this proceeding that it was entitled to recover its full embedded costs, but the Commission countered AEP Ohio's arguments by implementing a state compensation mechanism reaffirming RPM pricing for capacity. Stoddard Direct, p. 44. The most rational response for a CRES provider for that planning year would have been to operate under the only pricing structure which had ever been in effect, RPM.

<sup>311</sup> Banks Direct, p. 10.

<sup>312</sup> Allen Direct, p. 5.

illustrated in the graph below, even so, AEP Ohio's switch rate would still be the lowest in the state because other EDUs have established switch rates ranging from 51% - 78%.<sup>313</sup>



AEP Ohio has not hid its intent and anti-competitive self-interest in seeking an above-market price for capacity. **AEP Ohio's spokesperson specifically described AEP Ohio's Proposed Capacity Pricing as "critical to prevent a flood of customers from switching to competitors."**<sup>314</sup> AEP Ohio witness Munczinski linked previous AEP Ohio capacity pricing proposals to limits on shopping; he has admitted that even a (lower) \$255/MW-day capacity price would "constrain[]" shopping: "Over those [shopping cap] percentages, if you want to shop, you pay the full cost of \$255 per megawatt day. So the thought and the theory is that the shopping will be constrained to [those customers eligible to receive] the discounted RPM

<sup>313</sup> Banks Direct, p. 10 *citing* PUCO, Division of Market Monitoring & Assessment, "Summary of Switch Rates from EDUs to CRES Providers in Terms of Sales For the Month Ending December 31, 2011."

<sup>314</sup> Banks Direct, Ex. TCB-6, Gongwer Ohio Report, "AEP Says New Rate Plan Is 'Pro-Competitive'; FirstEnergy Still Opposed," Mar. 30, 2012.

price.”<sup>315</sup> AEP Ohio’s goals in limiting its competition more generally also have been explicit and unwavering. AEP’s CEO has stated, point-blank, “I don’t like customers switching in Ohio” and that “there is a concern over the opportunity of customers to shop.”<sup>316</sup> AEP’s CFO also publicly stated that AEP has instituted “regulatory responses to customers switching” that it sought to continue.<sup>317</sup>

AEP Ohio’s unabashed and desperate resistance to competition raises serious concerns for the Commission, customers, and competitors. The competitive market for retail electric generation service, including capacity, has provided significant benefits to customers in other EDUs’ service territories and the process for promoting those benefits is now well-established. AEP Ohio already has an unfair advantage in the competitive market in its service territory and there is no basis on which to provide AEP Ohio with even more advantages that would undercut the incentives of the competitive market. The above-market revenue stream that AEP Ohio seeks in this proceeding is unjustified, improper, and harmful to the competitive market and customers, and should be rejected.

#### **IV. CONCLUSION**

AEP Ohio has failed to establish any justification for departing from the RPM-based pricing, which provides significant value to customers, and so its request to modify Ohio’s capacity compensation mechanism should be denied. RPM-based pricing should be reinstated as Ohio’s state compensation mechanism for capacity.

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<sup>315</sup> Banks Direct, p. 10 *citing* AEP Conference Call to Announce Stipulation, Final Transcript, Sept. 7, 2011 (emphases added).

<sup>316</sup> Banks Direct, p. 10 *citing* AEP-Q3 2010 American Electric Power Earnings Conference Call, Oct. 19, 2010, Final Transcript *and* Sanford C. Bernstein & Co. Strategic Decisions Conference, Fireside Chat with Mike Morris, AEP Chairman and CEO, Jun. 1, 2011.

<sup>317</sup> Banks Direct, p. 10 *citing* American Electric Power Earnings Conference Call, Final Transcript, Jan. 28, 2011).

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I hereby certify that a copy of the foregoing *Post Hearing Brief Of FirstEnergy Solutions Corp.* was served this 23rd day of May, 2012, via e-mail upon the parties below.

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