BOEHM, KURTZ & LOWRY
ATTORNEYS AT LAW
36 EAST SEVENTH STREET
SUITE 1510
CINCINNATI, OHIO 45202
TELEPHONE (513) 421-2255

TELECOPIER (513) 421-2764

Via E-file

May 23, 2012

Public Utilities Commission of Ohio
PUCO Docketing
180 E. Broad Street, 10th Floor
Columbus, Ohio 43215

In re: Case No. 10-2929-EL-UNC

Dear Sir/Madam:

Please find attached the POST-HEARING BRIEF OF THE OHIO ENERGY GROUP e-filed today in the above-referenced matter.

Please place this document of file. Copies have been served on all parties listed on the attached Certificate of Service.

Respectfully yours,

Michael L. Kurtz, Esq.
BOEHM, KURTZ & LOWRY

MLKkew
Encl.
Cc: ALJ Greta See, Esq. (via electronic mail)
ALJ Sarah Parrot, Esq. (via electronic mail)
Chairman Todd A. Snitchler (via overnight mail)
Commissioner Cheryl Roberto (via overnight mail)
Commissioner Steven D. Lesser (via overnight mail)
Commissioner Andre T. Porter (via overnight mail)
Commissioner Lynn Slaby (via overnight mail)
Eric Weldele, PUCO Chief of Staff (via overnight mail)
Certificate of Service

BEFORE THE
PUBLIC UTILITY COMMISSION OF OHIO

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

POST-HEARING BRIEF OF THE OHIO ENERGY GROUP

David F. Boehm, Esq.
Michael L. Kurtz, Esq.
Kurt J. Boehm, Esq.
BOEHM, KURTZ & LOWRY
36 East Seventh Street, Suite 1510
Cincinnati, Ohio 45202
Ph: (513) 421-2255 Fax: (513) 421-2764
E-Mail: dboehm@BKLlawfirm.com
mkurtz@BKLlawfirm.com
kboehm@BKLlawfirm.com

May 23, 2012

COUNSEL FOR THE OHIO ENERGY GROUP

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POST-HEARING BRIEF OF
THE OHIO ENERGY GROUP

The Ohio Energy Group ("OEG") hereby submits this Brief in support of its recommendations in this proceeding. OEG's members who are participating in this proceeding are: AK Steel Corporation, Aleris International, Inc., Amsted Rail Company, Inc., ArcelorMittal, USA, BP-Husky Refining, LLC, E.I. DuPont de Nemours & Company, Ford Motor Company, GE Aviation, Linde, Inc., O-I aka Owens-Brockway Glass Container, Inc., Praxair Inc., RG-Steel, The Timken Company and Worthington Industries. OEG's recommendations are set forth below.

I. INTRODUCTION

If equity and fairness are appropriate considerations, then some historical perspective is helpful to properly decide this case.

Since S.B. 3 was enacted in 1999 and Ohio began its long march to market-based generation supply, Ohio Power Company ("AEP Ohio") has consistently been a below-market supplier.[1] While states like Maryland and Illinois suffered through calamitous rate hikes and near ratepayer rebellion caused by an undeveloped and dysfunctional wholesale power market, Ohio consumers benefited from below-market prices made possible by Rate Stabilization Plans ("RSPs") initiated by the Public Utilities Commission of Ohio ("PUCO" or "Commission") during

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[1] References to AEP Ohio recognize that Columbus Southern Power Company and Ohio Power Company were recently merged into Ohio Power Company.

2006-2008 (for which there was scant legislative authority). The below-market rates generally continued during AEP Ohio's first Electric Security Plan ("ESP") under S.B. 221. Maintaining below-market rates when AEP Ohio arguably had a legal basis to do otherwise was no doubt beneficial to the Ohio economy. This is the narrative AEP Ohio likes to tell, and it is true. But there is more to the story.

The RSPs and first ESP also authorized AEP Ohio to automatically increase rates by fixed percentage amounts with no cost-of-service justification and with no regard to current earnings. The rationale was that cost and earnings were not relevant so long as rates remained below the then-dysfunctional and abnormally high market price. These RSP and ESP fixed percentage rate increases resulted in great profitability for the two AEP Ohio utilities until Columbus Southern Power Company ("CSP") became the most profitable investor-owned electric utility in America by far in 2009 and 2010. Even after CSP's 2009 SEET refund, CSP remained one of the most profitable electric utilities in the nation. Ohio Power Company was solidly profitable during the same time period as well. These record-setting profits were achieved in a low-risk environment when AEP Ohio faced little threat from competition for retail customers. Reduced shopping risk for AEP Ohio was aided by the Commission's first ESP decision. During 2009-2011, AEP Ohio charged less than its actual fuel costs (at March 31, 2012 the Phase-in Recovery Rider deferral balance was $549 million). This deferral substantially reduced the price-to-compare and attendant shopping risk, and will be recovered on a non-bypassable basis. Thus, from 2006-2011, it was the best of both words for AEP Ohio.

Now times have changed. A confluence of events have caused PJM RPM capacity prices over the next two Planning Years (2012/2013 and 2013/2014) to be unusually low. Fracking and the new shale discoveries have caused natural gas prices to fall to levels many thought would never be seen again. These low gas prices have caused energy prices, especially on-peak prices, to decline dramatically. Natural gas combined cycle plants now routinely dispatch ahead of what was once referred to as "base load" coal generation. The EPA's war on coal and coal generation has caused that technology to suffer as well.

OEG understands the Commission's policy decision to move toward full generation divestiture. And we understand the stated goal of a transition period. But despite the need to transition and AEP Ohio's history of below market rates (combined with record profits) described above, AEP Ohio's position in this case is an over-reach. AEP Ohio stubbornly seeks to maintain or even grow earnings during the transition to full deregulation, and thus deprive consumers of virtually all of the benefits of low market capacity and energy pricing. OEG cannot support that.

As discussed below, OEG proposes a plan which we believe strikes a fair balance during the transition period. One that promotes the development of a competitive market and provides real savings to consumers by pricing capacity at some variant of RPM, while at the same time protecting the financial integrity of the utility by placing a floor on its total company earnings.

II. SUMMARY OF ARGUMENT

Just two months ago this Commission asserted to FERC that it seeks to achieve two goals in determining the capacity price that AEP Ohio can charge to competitive retail electric service ("CRES") providers: 1) promoting retail competition; and 2) allowing the utility to earn a return sufficient to attract capital investment.[2] OEG's recommendations are aimed at assisting the Commission in achieving those two goals.

By establishing an RPM-based price as the state capacity compensation mechanism, the Commission can achieve its first goal of promoting retail competition since an RPM-based price does not undermine the benefits of shopping, unlike AEP Ohio's proposed capacity price. Further, the adoption of the average RPM price for the next three PJM planning years could help the Commission achieve its second goal of allowing AEP Ohio the ability to attract capital investment by mitigating significant fluctuations in future RPM capacity prices.

[2] OEG Exhibit 101; Motion for Leave to Answer and Answer Submitted on Behalf of the Public Utilities Commission of Ohio to PJM Interconnection, L.L.C. Response to AEP Motion for Expedited Ruling, FERC Docket Nos. ER11-2183 and EL11-32 (March 22, 2012) ("PUCO Answer") at 4.

But if the Commission ultimately determines that a cost-based capacity price should be established as the state compensation mechanism during a three year transition period, then pricing for cost-based capacity should be accomplished in two steps. First, in no event should the Commission set a capacity price for CRES providers that exceeds the $145.79/MW-day RPM price in effect at the end of 2011. That capacity price has proven sufficient both for AEP Ohio to earn a reasonable return on equity and for customers to engage in shopping in AEP Ohio's service territory.

Second, the Commission should establish an Earnings Stabilization Mechanism ("ESM") to ensure that the cost-based compensation results in utility earnings that fall within a Commission established bandwidth or zone of reasonableness. Currently, significant uncertainty exists regarding both: 1) what constitutes a reasonable cost-based capacity price; and 2) the impact of various capacity prices on AEP Ohio's earnings. In the midst of such significant uncertainty, the ESM acts as a safeguard to ensure that the capacity pricing mechanism ultimately adopted does not result in over- or under-compensation for AEP Ohio's capacity.

III. ARGUMENT

On March 22, 2012, the Commission made these statements to the Federal Energy Regulatory Commission ("FERC"):

> *"It is evident that the Ohio Commission is endeavoring to arrive at a CRES capacity rate that will promote alternative competitive supply and retail competition while simultaneously ensuring an incumbent electric utility provider's ability to attract capital investment to meet its FRR obligations. Arriving at this delicate balance is not a perfunctory endeavor.*
>
> ***
>
> *Contrary to PJM's allegations, as mentioned earlier, the Ohio Commission is endeavoring to arrive at a CRES capacity pricing mechanism that will incent customer choice while simultaneously safeguarding the necessary access to capital by the incumbent electric utility to ensure reliability. Moreover, the Ohio Commission is striving to safeguard an orderly transition for AEP-Ohio into the competitive marketplace.*
>
> ***

The Ohio Commission has the resources to arrive at a reasonable CRES capacity charge that will promote competition while providing the electric utility access to the necessary capital to ensure reliability."[3]

OEG's position in this case has been guided by the assurances given by this Commission to FERC.

A. The Commission Should Establish Either the Annual or the Average RPM-based Capacity Price for the Next Three PJM Planning Years as the Price That AEP Ohio Can Charge CRES Providers Under the State Compensation Mechanism.

The Commission should establish the RPM-based capacity price of $20.01/MW/day for 2012/2013, $33.71/MW/day for 2013/2014 and $153.89/MW/day for 2014/2015 as the price that AEP Ohio can charge CRES providers under the state compensation mechanism.[4] Standard Service Offer ("SSO") customers would continue to pay existing SSO base generation rates, unless and until there is an SSO auction. In addition, the Commission should apply the state compensation mechanism uniformly to all CRES providers. The two-tiered capacity pricing system should not be continued. A uniform capacity price for CRES providers reduces concerns about discriminatory pricing, lessens customer confusion regarding the queuing process, and is easier to administer.

The Commission's adoption of an RPM-based capacity price as the price that AEP Ohio can charge CRES providers under the state compensation mechanism maintains consistency with past and current practices and encourages retail competition. An RPM-based price is what AEP Ohio previously charged CRES providers for capacity and is what at least one tier of shopping customers continue to pay under the Commission's March 7, 2012 Entry in this case. Conversely, AEP Ohio's proposed cost-based rate of $355.72/MW-day represents a drastic departure from this precedent. AEP Ohio's proposed capacity price would deter shopping thus undermining the benefits of retail competition, which is contrary to the Commission's first goal.[5] The Commission can avoid the chilling effects on retail competition that would result from AEP Ohio's proposed capacity price by adopting RPM-based capacity prices as the state compensation mechanism. Under RPM-based capacity pricing in 2011,

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[3] Id.

[4] Direct Testimony and Exhibits of Lane Kollen (April 4, 2012) ("Kollen Testimony") at 9:7-13.

[5] Direct Testimony of Tony C. Banks on Behalf of FirstEnergy Solutions Corp. (April 4, 2012) at 5:14-7:4; Direct Prepared Testimony of Theresa L. Ringenbach on Behalf of the Retail Energy Supply Association (April 4, 2012) at 12:16-20.

customer shopping in AEP Ohio's territory has steadily increased.[6] Since RPM-based pricing facilitates customer shopping, such pricing is consistent with state policy as outlined in R.C. 4928.02 and with the Commission's first goal of encouraging retail competition.[7]

To mitigate some of the financial impact of future RPM prices on AEP Ohio, the Commission could adopt a three-year average of the RPM capacity prices for the next three PJM planning years as AEP Ohio's capacity price for CRES providers. Such an approach can assist in balancing the Commission's twin goals by allowing AEP Ohio to earn a return sufficient to attract investment without deterring retail shopping in AEP Ohio's service territory. Over the next three PJM planning years, the RPM price averages $69.20/MW-day. This is more than triple the RPM capacity rate for the 2012/2013 planning year, nearly double the rate for the 2013/2014 planning year, and less than half of the rate for the 2014/2015 year. By adopting the average RPM price for the next three PJM planning years as the state compensation mechanism, the Commission provides AEP Ohio with more up-front revenue than the Company would otherwise receive by relying purely on current market prices for capacity. Further, the Commission provides greater price stability to AEP Ohio by mitigating the significant fluctuations in RPM capacity prices in the coming years. This approach also has the advantage of maintaining market-based pricing that can ease AEP Ohio's ultimate transition to becoming an RPM entity.

The establishment of a capacity price for CRES providers using either annual or average RPM prices is consistent with the Commission's first goal of encouraging retail competition because the RPM price represents the market value of capacity and does not undermine the benefits of shopping, unlike AEP Ohio's proposed capacity price of $355.72/MW-day. Additionally, using at least the average of the RPM capacity prices in the next three PJM planning years can help the Commission achieve its second goal by granting AEP Ohio additional capacity revenue in the first two years of the transition than it may otherwise receive, providing greater price stability, and easing AEP Ohio's transition to becoming an RPM entity. Therefore, the Commission should establish either the annual or the

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[6] Kollen Testimony at 11:6-8.

[7] R.C. 4928.02(C)(stating that it is the policy of the state to "[e]*nsure diversity of electricity supplies and suppliers, by giving consumers effective choices over the selection of those supplies and suppliers and by encouraging the development of distributed and small generation facilities."*).

average RPM-based price as the capacity price that AEP Ohio can charge to CRES providers under the state compensation mechanism.

B. If the Commission Establishes a Cost-Based State Compensation Mechanism Then It Should Be Accomplished In Two Steps: First, The Capacity Price Should Not Exceed the 2011/2012 RPM-price of $145.79/MW-day; Second, Total Company Earnings Should Be Maintained With A Commission Determined Zone Of Reasonableness.

If the Commission ultimately determines that RPM prices are inadequate to satisfy the Commission's twin goals and that a cost-based mechanism should be adopted instead, then the cost-based mechanism should incorporate two steps. First, the capacity price should not exceed the current RPM of $145.79/MW-day. Second, the total earnings of AEP Ohio should be maintained within a Commission-determined zone of reasonableness.

1. The Current RPM Of $145.79/MW-Day Is A Reasonable Initial Capacity Price For A Cost-Based Compensation Mechanism.

A capacity price for CRES providers of $145.79/MW-day allowed AEP Ohio to earn a more than sufficient return in 2011. In 2011, AEP Ohio's return on equity was 11.42%, after adjustments to remove plant impairment expense and non-recurring provider-of-last-resort revenue.[8] On a per books (unadjusted) basis, AEP Ohio's 2011 return on equity was 10.21%.[9] Thus, AEP Ohio was able to earn a relatively high return on equity with RPM-based capacity prices of $145.79/MW-day at the end of 2011.[10] And AEP Ohio's return on equity appears even larger when compared to the per books (unadjusted) returns on equity of the AEP East affiliated utilities, which averaged 6.8% in 2010 and 7.8% in 2011:[11]

	2010	2011
Appalachian Power	4.9%	5.6%
Indiana & Michigan	7.5%	8.6%
Kentucky Power	8.0%	9.3%
Average	**6.8%**	**7.8%**

[8] Ex. LK-3.
[9] Ex. LK-3.
[10] Kollen Testimony at 11:5-6.
[11] Kollen Testimony at 13:1-9.

AEP Ohio's 2011 per books (unadjusted) return on equity of AEP Ohio of 10.21% was significantly higher than its regulated affiliates in the AEP East Power Pool over the past two years. Accordingly, the end of 2011 RPM rate of $145.79/MW-day represents an appropriate ceiling for AEP Ohio's capacity charges to CRES providers under the state compensation mechanism.

Moreover, the RPM-based rate of $145.79/MW-day charged at the end of 2011 enabled a significant amount of customer shopping. In the first quarter of 2011, when the RPM capacity rate was higher ($220.96/MW/day), only 7.1% of AEP Ohio's total load had switched.[12] But by the end of 2011, when the capacity rate was $145.79/MW-day, customer switching by class was: Residential - 5.53%; Commercial - 33.88%; and Industrial - 18.26%.[13] Hence, 19.10% of the Company's total load had switched to CRES providers by the end of 2011.[14] OEG witness Lane Kollen testified that "*[t]his indicates that the competitive market will continue to develop even further if the total capacity compensation to AEP Ohio is no greater than the end of 2011 RPM of $145.79/MW/day.*"[15]

Further, the maximum capacity price of $145.79/MW-day is very close to Staff's proposed cost-based capacity figure of $146.41/MW-day.[16] And AEP Ohio has adopted the $145.79/MW-day figure as the price for Tier 1 customers of CRES providers in the Company's modified ESP proposal.[17] This provides further evidence that a capacity price of $145.79/MW-day is reasonable. Notably, the maximum above market premium that would be provided under a capacity price of $145.79/MW-day is comparable to the capacity premiums currently paid by customers elsewhere in Ohio. In Duke Energy Ohio's most recent ESP case, the Commission approved RPM pricing *plus* a nonbypassable Electric Service Stability Charge ("ESSC") that increased rates by $5.40/MWh on average for all Duke customers, including SSO customers.[18] Subtracting the three-year average RPM price of

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[12] Kollen Testimony at 11:9-11.
[13] Kollen Testimony at 11:8-9.
[14] Kollen Testimony at 11:6-8.
[15] Kollen Testimony at 11:11-14.
[16] Ex. ESM-4.
[17] Direct Testimony of William A. Allen in Support of AEP Ohio's Modified Electric Security Plan, Case Nos. 11-346-EL-SSO *et al* (March 30, 2012) at 6:10-13.
[18] Kollen Testimony at 12:6-8.

$69.20/MW-day from a capacity price of $145.79/MW-day results in a maximum premium above RPM of $76.59/MW-day.[19] For an average shopping customer with a 60% load factor, the RPM premium paid to AEP Ohio would be $5.30/MWh.[20] And, unlike in the case of Duke, the above-market premium of $76.59/MW-day would apply only to shopping customers.

An RPM-based rate of $145.79/MW-day has proven effective in satisfying the Commission's twin goals in this proceeding. Such a capacity price provides a more than sufficient to return to AEP Ohio while still fostering retail competition in AEP Ohio's territory. Consequently, in striving to achieve the balance the Commission seeks in this case, the Commission should in no event establish a capacity price greater than $145.79/MW-day for CRES providers.

2. **In The Midst Of The Significant Uncertainty Surrounding The Proper Cost-Based Capacity Price And The Impact Of Various Capacity Prices On AEP Ohio's Earnings, The Commission Should Adopt A Earnings Stabilization Mechanism As A Safeguard To Ensure Against Over- Or Under-Compensating AEP Ohio.**

Significant uncertainty exists regarding both the proper cost-based price for AEP Ohio's capacity and the impact of various capacity prices on AEP Ohio's earnings. Given the wide spectrum of opinions presented by experts in this case, there is substantial risk that unless trued-up to actual earnings the Commission's decision on a cost-based capacity compensation mechanism for AEP Ohio could result in either over- or under-compensation to the Company once that mechanism operates in combination with the rest of AEP Ohio's rate structure. In light of this significant uncertainty, the Commission should establish an ESM as part of a cost-based state compensation mechanism to ensure that actual earnings fall within a Commission prescribed zone of reasonableness.

[19] Kollen Testimony at 11:22-12:2 ($145.79-$69.20 = $76.59).
[20] Kollen Testimony at 12:8-11.

Examining the recommendations of various parties in this case, it becomes apparent that there are a wide range of proposals regarding the proper cost-based capacity price for AEP Ohio. For example, the proposals include:

FirstEnergy	**Staff**	**AEP Ohio**
$78.53/MW-day[21]	$146.41/MW-day[22]	$355.72/MW-day[23]

This wide range of proposals indicates that there is great uncertainty about the appropriate cost-based capacity pricing number the Commission should adopt in this case. By far, the largest part of that uncertainty centers around predictions of future on-peak and off-peak market energy prices and the energy off-set to fixed capacity costs. The results of such market energy forecasts can vary drastically depending upon multiple assumptions and methodologies (fundamental or futures based) used in the forecasting, including the dates on which the information used in forecasting was compiled.[24] Even if there were agreement about the correct level of the energy off-set to fixed capacity costs, how those energy credits flow through the AEP Pooling Agreement, and when the AEP Pooling Agreement will be terminated, provide additional significant uncertainty regarding a "correct" cost-based capacity compensation rate.

It is difficult to consider the impact of various capacity pricing on AEP Ohio's earnings in isolation from the rest of AEP Ohio's rate structure, which could be modified as a result of the pending ESP proceeding. The additional revenue from mechanisms that AEP Ohio proposed in its ESP case could have a significant impact on AEP Ohio's earnings projections. Because the Commission is faced with significant uncertainty regarding the ultimate impact of various capacity prices when combined with any mechanisms ultimately established in AEP Ohio's modified ESP, the Commission should proceed with caution. If the Commission agrees with AEP Ohio that earnings are important, then it is inherently more accurate to rely on earnings that are trued-up to actual to maintain the utility's profitability within a Commission-determined upper and lower bound, rather than rely on projections.

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[21] Direct Testimony Jonathan A. Lesser (April 4, 2012) at 56, Table 7.
[22] Ex. ESM-4.
[23] Direct Testimony of Kelley Pearce at 21.
[24] See Staff Ex. 110.

An ESM would serve to "true-up" AEP Ohio's annual earnings based upon the Company's actual costs. Under the ESM, the Commission would set an earnings benchmark as well as an earnings upper and lower bound. If AEP Ohio's annual earnings were above or below the ESM upper or lower bound, the Commission would "true-up" the earnings through either a nonbypassable credit or a surcharge to customers. The ESM would only be established for as long as the Company owns generation assets. Once AEP Ohio has divested its generation assets, the Commission could explore other methods for ensuring that the state compensation mechanism is continuing to work effectively.

If it seems curious to focus so much on cost-of-service, rate of return and earnings in a jurisdiction which allows retail access, two things should be remembered. First, pursuant to the PJM tariff, it is AEP Ohio that is seeking cost-based compensation for its generation. Second, this approach is only transitional.

OEG recommends that the Commission should establish an ESM earnings midpoint at 9.0%, with a bandwidth set at 200 basis points above and below the midpoint. Thus, the lower threshold would be 7.0% and the upper threshold would be 11.0%. If AEP Ohio's total company earnings are below the lower threshold of 7.0%, then the Company would be allowed to increase its rates through an ESM charge sufficient to increase their earnings to the lower threshold. If AEP Ohio's total company earnings are above the upper threshold of 11.0%, then it would credit the excess earnings to customers through an ESM credit. If AEP Ohio's earnings are within the ESM bandwidth, then there would be no rate changes other than those that operate to recover defined costs, such as the Fuel Adjustment Clause.[25] Of course, the Commission has discretion to set the zone of reasonableness at different levels which it determines are appropriate.

The reasonableness of the 7.0% lower ESM threshold is confirmed by the actual earned returns of the AEP East affiliates discussed above, whose returns on equity averaged 6.8% in 2010 and 7.8% in 2011. Additionally, AEP Ohio's adjusted 2011 return on equity ("ROE") was approximately 11%. Each 100 basis points is equivalent to a $70 million change in revenue requirements.[26] Accordingly, there would need to be a net revenue decrease or expense increase of approximately $280 million before customers would be charged for an earnings deficit below

[25] Kollen Testimony at 18:9-20.
[26] Ex. LK-3.

the earnings floor of 7.0%.[27] In other words, before the ESM resulted in any charge to consumers, AEP Ohio would have to suffer through an earnings decline of $280 million annually, and consumers would save a like amount from shopping.

A total company ROE of 7.0% implies earnings on generation of about 5.0% (assuming a 10% ROE on regulated transmission and distribution). A 5.0% ROE on AEP Ohio's generation investment roughly equates to the cost of long-term debt and should not be viewed as generous. Moreover, in the currently pending ESP Modification Case, AEP Ohio witness Sever testified that if the ESP was approved exactly as AEP Ohio requested, then the Company's projected return on equity in 2013 would be 7.5%.[28] Mr. Sever's projection assumed that shopping levels at the end of 2012 would be 65% Residential, 80% Commercial and 90% Industrial (excluding one large special contract customer) and remain at those very high levels for the balance of the three year plan.[29] Because 7.5% would be the resultant return on equity in 2013 if AEP Ohio's ESP was adopted as filed, the Company would be hard pressed to argue that an ESM lower bound of 7% is not reasonable.

A total company earnings floor of 7.0% would treat AEP Ohio similarly, but slightly better, than Duke Ohio. As quantified in its recent SEET filing, Duke earned an ROE of between 5.84% and 6.21% in 2011.[30] These earnings were achieved during a year when Duke had lost virtually all of its commercial and industrial load to shopping. These earnings were also achieved before Duke's $110 million ESSC Rider became effective and before its SSO load was put up for auction. It is impossible to know how much of Duke's former customer base (and associated profit) was picked up by Duke unregulated. Just as it is impossible to know how much of AEP Ohio's former customer base (and associated profit) will be picked up the unregulated AEP marketing affiliate.

The ESM would work in conjunction with the general framework established by the Commission for the annual SEET review, which would continue and would merely be expanded to include the ESM review. Earnings generally would be calculated on the same basis as the SEET methodology. For example, deferrals and the related

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[27] Kollen Testimony at 18:21-19:3.
[28] Case No. 11-346-EL-SSO, Exhibit OJS-2, p. 1.
[29] *Id*.
[30] Case No. 12-1280-EL-UNC, Direct Testimony of Peggy Laub at 13.

amortization expense would be included in the earnings while extraordinary, nonrecurring, and special items would be excluded.[31] But the ESM review would also incorporate off-system sales margins in the earnings calculations since all of the costs incurred by the Company to generate the off-system sales and margins would be included in the calculation of earnings.[32] This methodology is consistent with using energy margins (e.g., off-system sales) to reduce fixed generation costs in the cost-based capacity pricing formula advocated (or at least conceded) by all parties here. Consistent with the SEET methodology, any credit or charge from the prior year would be excluded in the calculation of earnings for the current year.[33] The ESM credit or ESM charge would be nonbypassable and would be allocated on a kWh basis similar to the SEET refund.

The Commission may have a legal obligation to ensure that AEP Ohio is reasonably compensated for its capacity obligations, such that AEP Ohio has the opportunity to earn at least a non-confiscatory return on its generation investment.[34] And PJM has stated that the intent of the Reliability Assurance Agreement section at issue, Schedule 8.1, Section D.8 is to "*compensate* AEP Ohio for the cost to satisfy its FRR capacity obligations associated with load reflected in AEP Ohio's FRR Capacity Plan that has instead chosen to be served by CRES Providers"[35] But AEP Ohio is not legally required to get cost-based capacity rates if those rates would lead to an excessive return on equity. Ultimately, AEP Ohio's rates must fall within a "zone of reasonableness."[36] Consequently, the Commission should ensure that the capacity compensation mechanism established in this case does not result in rates for the Company that are so low or so high as to fall outside of that "zone of reasonableness" by establishing an ESM to act in combination with the state compensation mechanism.

The ESM allows the Commission to fix a capacity price for a period of time without concern that it is either too high or too low. This allows consumers to better make informed shopping decisions, which will promote competition

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[31] Such extraordinary items would include power plant retirements (unless the PUCO authorizes a deferral and establishment of a regulatory asset).

[32] Kollen Testimony at 19:10-17.

[33] Kollen Testimony at 19:18-20:2.

[34] *Bluefield Water Works v. West Virginia* (1923), 262 U.S. 679, 692-93; *Federal Power Comm. v. Hope Natural Gas* (1944), 320 U.S. 591, 603, 64 S.Ct. 281; *Cleveland Elec. Illuminating v. Pub. Util. Comm'n*, 4 Ohio St. 3d 107, 109, 447 N.E.2d 746 (1983).

[35] LK-2 (emphasis added).

[36] *Cleveland Elec. Illuminating v. Pub. Util. Comm'n*, 4 Ohio St. 3d 107, 109, 447 N.E.2d 746 (1983).

and further the development of a competitive market. Plus, the ESM provides a minimum return on equity to safeguard the Company and a maximum return on equity to safeguard customers so that the state compensation mechanism is not confiscatory on the one hand or overly compensatory on the other hand. Accordingly, the ESM provides reassurance that the Commission's ultimate decision in this case will further its twin goals of promoting competition and preserving the utility's ability to attract capital during the transition period before AEP Ohio becomes an RPM entity.

IV. CONCLUSION

OEG elects to not take sides in the battle now being waged between AEP and FirstEnergy. These important and well managed electric utilities, both headquartered in Ohio and both integral parts of the Ohio economy, have historically been key partners with the industrial manufacturers that comprise OEG. That partnership has helped grow and maintain high wage, high benefit, family supportive jobs in this state. In the spirit of continuing the working partnership that OEG seeks to maintain with all of this State's electric utilities, we submit for the Commission's consideration a proposal we feel is balanced.

Respectfully submitted,

David F. Boehm, Esq.
Michael L. Kurtz, Esq.
Kurt J. Boehm, Esq.
BOEHM, KURTZ & LOWRY
36 East Seventh Street, Suite 1510
Cincinnati, Ohio 45202
Ph: (513) 421-2255 Fax: (513) 421-2764
E-Mail: dboehm@BKLlawfirm.com
mkurtz@BKLlawfirm.com
kboehm@BKLlawfirm.com

May 23, 2012

COUNSEL FOR THE OHIO ENERGY GROUP

CERTIFICATE OF SERVICE

I hereby certify that true copy of the foregoing was served by electronic mail (when available) or ordinary mail, unless otherwise noted, this 23RD day of May, 2012 to the following:

David F. Boehm, Esq.
Michael L. Kurtz, Esq.

DOMINION RETAIL, INC.
GARY A. JEFFRIES
501 MARTINDALE STREET SUITE 400
PITTSBURGH PA 15212-5817

FIRSTENERGY SOLUTIONS MANAGER
MARKET INTELLIGENCE
LOUIS M D'ALESSANDRIS
341 WHITE POND DR
AKRON OH 44320

OHIO PARTNERS FOR AFFORDABLE ENERGY
RINEBOLT DAVID C
231 WEST LIMA ST. PO BOX 1793
FINDLAY OH 45839-1793

*RINEBOLT, DAVID C MR.
OHIO PARTNERS FOR AFFORDABLE ENERGY
231 W LIMA ST PO BOX 1793
FINDLAY OH 45840-1793

KROGER CO
LINDA VIENS
60 WORTHINGTON MALL
WORTHINGTON OH 43085

KRAVITZ, ZACHARY D.
CHESTER, WILCOX & SAXBE, LLP
65 EAST STATE STREET, STE 1000
COLUMBUS OH 43215

YURICK, MARK S.
65 EAST STATE STREET SUITE 1000
COLUMBUS OH 43215-4213

*NOURSE, STEVEN T MR.
AMERICAN ELECTRIC POWER SERVICE CORPORATION
1 RIVERSIDE PLAZA, 29TH FLOOR
COLUMBUS OH 43215

*COCHERN, CARYS
DUKE ENERGY
155 EAST BROAD ST 21ST FLOOR
COLUMBUS OH 43215

*RANDAZZO, SAMUEL C. MR.
MCNEES WALLACE & NURICK LLC
21 E. STATE STREET, 17TH FLOOR
COLUMBUS OH 43215

*SUGARMAN, ROGER P. MR.
KEGLER BROWN HILL & RITTER CO., LPA
65 EAST STATE STREET SUITE 1800
COLUMBUS OH 43215

*DARR, FRANK P MR.
MCNEES, WALLACE & NURICK LLC
21 E. STATE STREET 17TH FLOOR
COLUMBUS OH 43215

*KUTIK, DAVID A MR.
JONES DAY
901 LAKESIDE AVENUE
CLEVELAND OH 44114

*ALEXANDER, NATHANIEL TREVOR MR.
CALFEE, HALTER & GRISWOLD, LLP
21 E. STATE ST., SUITE 1100
COLUMBUS OH 43215

STINSON, DANE
BAILEY CAVALIERI LLC
10 WEST BROAD STREET SUITE 2100
COLUMBUS OH 43215

*SATTERWHITE, MATTHEW J MR.
AMERICAN ELECTRIC POWER SERVICE CORPORATION
1 RIVERSIDE PLAZA, 29TH FLOOR
COLUMBUS OH 43215

*THOMPSON, MELISSA L. MS.
WHITT STURTEVANT LLP
PNC PLAZA, SUITE 2020 155 EAST BROAD STREET
COLUMBUS OH 43215

*VOGEL, ANNE M
AMERICAN ELECTRIC POWER SERVICE CORPORATION
1 RIVERSIDE PLAZA
COLUMBUS OH 43215

*DUFFER, JENNIFER MRS.
ARMSTRONG & OKEY, INC.
222 EAST TOWN STREET 2ND FLOOR
COLUMBUS OH 43215

*HAQUE, ASIM Z. MR.
ICE MILLER LLP
250 WEST STREET
COLUMBUS OH 43215

*MCBRIDE, LAURA C. MS.
CALFEE, HALTER & GRISWOLD LLP
1400 KEYBANK CENTER 800 SUPERIOR AVE.
CLEVELAND OH 44114

WIGHT, PAUL F.
SKADDEN,ARPS,SLATE,MEAGHER & FLOM LLP
1440 NEW YORK AVENUE, N.W.
WASHINGTO, DC 20005

*BINGHAM, DEB J. MS.
OFFICE OF THE OHIO CONSUMERS' COUNSEL
10 W. BROAD ST., 18TH FL.
COLUMBUS OH 43215

*PETRICOFF, M HOWARD
VORYS SATER SEYMOUR AND PEASE LLP
52 E. GAY STREET P.O. BOX 1008
COLUMBUS OH 43216-1008

*MALLARNEE, PATTI
THE OFFICE OF THE OHIO CONSUMERS COUNSEL
10 W. BROAD ST. SUITE 1800
COLUMBUS OH 43215

MCBRIDE, LAURA
CALFEE HALTER & GRISWOLD LLP
1400 KEYBANK CENTER 800 SUPERIOR AVE
CLEVELAND OH 44114

*LEACH-PAYNE, VICKI L. MS.
MCNEES WALLACE & NURICK LLC
21 E. STATE ST., 17TH FLOOR
COLUMBUS OH 43215

*RINEBOLT, DAVID C MR.
OHIO PARTNERS FOR AFFORDABLE ENERGY
231 W LIMA ST PO BOX 1793
FINDLAY OH 45840-1793

*LOUCAS, CATHRYN N. MS.
THE OHIO ENVIRONMENTAL COUNCIL
1207 GRANDVIEW AVENUE
COLUMBUS OH 43212

ALEXANDER, TREVOR
CALFEE HALTER & GRISWOLD LLP
1400 KEYBANK CENTER 800 SUPERIOR AVE
CLEVELAND OH 44114

DARR, FRANK P. ATTORNEY AT LAW
MCNEES WALLACE & NURICK LLC
21 EAST STATE STREET, 17TH FLOOR
COLUMBUS OH 43215-422

*ALVAREZ, MARIANNE M MS.
EXELON CORPORATION
101 CONSTITUTION AVE, NW SUITE 400 EAST
WASHINGTON DC 20001

*ORAHOOD, TERESA
BRICKER & ECKLER LLP
100 SOUTH THIRD STREET
COLUMBUS OH 43215-4291

HAEDT, ALLISON E. ATTORNEY AT LAW
JONES DAY
325 JOHN H. MCCONNELL BLVD., SUITE 600
COLUMBUS OH 43215-2673

GRACE, SANDY I-RU

*MOORE, CHRISTEN M MS.

EXELON BUSINESS SERVICES COMPANY, LLC
101 CONSTITUTION AVENUE, NW SUITE 400 EAST
WASHINGTON DC 20001

PORTER WRIGHT MORRIS & ARTHUR, LLP
41 SOUTH HIGH STREET 30TH FLOOR
COLUMBUS OH 43215

*PRITCHARD, MATTHEW R. MR.
MCNEES WALLACE & NURICK
21 EAST STATE STREET #1700
COLUMBUS OH 43215

*OLIKER, JOSEPH E. MR.
INDUSTRIAL ENERGY USERS-OHIO
21 EAST STATE STREET SUITE 1700
COLUMBUS OH 43215

SMALL, JEFFREY
OHIO CONSUMERS' COUNSEL
10 WEST BROAD STREET SUITE 1800
COLUMBUS OH 43215-3485

*LANG, JAMES F MR.
CALFEE HALTER & GRISWOLD LLP
1400 KEYBANK CENTER 800 SUPERIOR AVE.
CLEVELAND OH 44114

DUKE ENERGY RETAIL SALES LLC FKA CINERGY RETAIL SALES LLC VICE PRESIDENT
MATT WALZ
139 EAST FOURTH STREET EA600
CINCINNATI OH 45202

KINGERY , JEANNE W

DUKE ENERGY OHIO INC
139 E. FOURTH STREET, 1303-MAIN PO BOX 960
CINCINNATI OH 45201-0960

ASSOCIATION OF INDEPENDENT COLLEGES AND UNIVERSITIES OF OHIO
C/O CHRISTOPHER MILLER
ICE MILLER LLP 250 WEST STREET
COLUMBUS OH 43215

CITY OF GROVE CITY

CHRISTOPHER L. MILLER, IC
250 WEST STREET
COLUMBUS OH 43215

CONSTELLATION NEWENERGY INC
SENIOR COUNSEL
CYNTHIA FONNER BRADY
550 W WASHINGTON STREET SUITE 300
CHICAGO IL 60661

*PETRICOFF, M HOWARD

VORYS SATER SEYMOUR AND PEASE LLP
52 E. GAY STREET P.O. BOX 1008
COLUMBUS OH 43216-1008

DIRECT ENERGY SERVICES LLC MANAGER
GOVERNMENT & REGULATORY AFFAIRS
TERESA RINGENBACH
9605 EL CAMINO LANE
PLAIN CITY OH 43064

*PETRICOFF, M HOWARD
VORYS SATER SEYMOUR AND PEASE LLP
52 E. GAY STREET P.O. BOX 1008
COLUMBUS OH 43216-1008

DUKE ENERGY COMMERCIAL ASSET MANAGEMENT, INC.
139 E. FOURTH STREET, 1303-MAIN P.O. BOX 961
CINCINNATI OH 45201-0960

EXLON GENERATION COMPANY, LLC
101 CONSTITUTION AVE N.W., SUITE 400 EAST
WASHINGTON DC 20001

RODRIGUEZ, JESSE A ATTORNEY
300 EXELON WAY
KENNETT SQUARE PA 19348

INDUSTRIAL ENERGY USERS OF OHIO
GENERAL COUNSEL
SAMUEL C RANDAZZO

OLIKER, JOSEPH E ATTORNEY
MCNEE WALLACE & NURICK LLC

21 EAST STATE STREET, 17TH FLOOR
COLUMBUS OH 43215

21 EAST STATE STREET, 17TH FLOOR
COLUMBUS OHIO 43215

INTERSTATE GAS SUPPLY INC
VINCENT PARISI
6100 EMERALD PARKWAY
DUBLIN OH 43016

*THOMPSON, MELISSA L. MS.
WHITT STURTEVANT LLP
PNC PLAZA, SUITE 2020 155 EAST BROAD STREET
COLUMBUS OH 43215

INTERSTATE GAS SUPPLY INC
VINCENT PARISI
6100 EMERALD PARKWAY
DUBLIN OH 43016

*WHITT, MARK A
WHITT STURTEVANT LLP
PNC PLAZA, 20TH FLOOR 155 EAST BROAD STREET
COLUMBUS OH 43215

NFIB OHIO
ROGER P SUGARMAN
KEGLER, BROWN, HILL & RITTER
65 EAST STATE ST STE1800
COLUMBUS OH 43215

OHIO CONSUMERS' COUNSEL
10 W. BROAD STREET SUITE 1800
COLUMBUS OH 43215-3485

OHIO FARM BUREAU FEDERATION
CHAD A. ENDSLEY
280 N. HIGH STREET, PO BOX 182383
COLUMBUS OH 43218-2383

OHIO HOSPITAL ASSOCIATION
RICHARD L. SITES
155 E. BROAD STREET 15TH FLOOR
COLUMBUS OH 43215-3620

OHIO HOSPITAL ASSOCIATION
RICHARD L. SITES
155 E. BROAD STREET 15TH FLOOR
COLUMBUS OH 43215-3620

O'BRIEN , THOMAS
BRICKER & ECKLER LLP
100 SOUTH THIRD STREET
COLUMBUS OH 43215-4291

OHIO MANUFACTURERS' ASSOCIATION
33 N HIGH STREET
COLUMBUS OH 43215

MCALISTER, LISA G
BRICKER & ECKLER
100 SOUTH THIRD STREET
COLUMBUS OH 43215-4291

RETAIL ENERGY SUPPLY ASSOCIATION (RESA)
STEPHEN HOWARD
52 E. GAY ST.
COLUMBUS OH 43215

*PETRICOFF, M HOWARD
VORYS SATER SEYMOUR AND PEASE LLP
52 E. GAY STREET P.O. BOX 1008
COLUMBUS OH 43216-1008

AMERICAN ELECTRIC POWER
LEGAL DEPARTMENT
1 RIVERSIDE PLAZA
COLUMBUS OH 43215-2372

SATTERWHITE, MATTHEW
1 RIVERSIDE PLAZA 29TH FLOOR
COLUMBUS OH 43215

CONSTELLATION ENERGY GROUP, INC.

CYNTHIA A. FONNER, SENIOR
550 W. WASHINGTON BLVD, STE 300
CHICAGO IL 60661

DIRECT ENERGY BUSINESS LLC MANAGER GOVERNMENT & REGULATORY AFFAIRS
TERESA RINGENBACH
9605 EL CAMINO
PLAIN CITY OH 43064

ESTES III, JOHN N
1440 NEW YORK AVE N.W.
WASHINGTON D.C 20005

FIRSTENERGY SERVICE COMPANY
76 SOUTH MAIN ST
AKRON OH 44308

GARBER, GRANT W.
JONES DAY
P.O.BOX 165017 325
JOHN H MCCONNELL BLVD. STE 600
COLUMBUS OH 43215-2673

BENTINE, JOHN
CHESTER WILLCOX & SAXBE LLP
65 E. STATE STREET, SUITE 1000
COLUMBUS OH 43215

OHIO HOSPITAL ASSOCIATION
RICHARD L. SITES
155 E. BROAD STREET 15TH FLOOR
COLUMBUS OH 43215-3620

OHIO POWER COMPANY

1 RIVERSIDE PLAZA, 29TH FLOOR
COLUMBUS OH 43215

UNITED WAY OF JEFFERSON COUNTY
501 WASHINGTON STREET P.O. BOX 1463
STEUBENVILLE OH 43952

GARBER, GRANT W
JONES DAY
PO BOX 165017 SUITE 600
ALEXANDER, N TREVOR
CALFEE HALTER & GRISWOLD LLP
1100 FIFTH THIRD CENTER 21 EAST STATE STREET
COLUMBUS OH 43215-4243

WIGHT, PAUL F.
SKADDEN,ARPS,SLATE,MEAGHER & FLOM LLP
1440 NEW YORK AVENUE, N.W.
WASHINGTON, DC 20005

GRADY, MAUREEN
OFFICE OF CONSUMERS' COUNSEL
10 W. BROAD STREET SUITE 1800
COLUMBUS OH 43215-3485

SITES, RICHARD ATTORNEY AT LAW
OHIO HOSPITAL ASSOCIATION
155 EAST BROAD STREET 15TH FLOOR
COLUMBUS OH 43215-3620

NOURSE , STEVEN T. MR.
AMERICAN ELECTRIC POWER
1 RIVERSIDE PLAZA
COLUMBUS OH 43215