BEFORE THE
THE PUBLIC UTILITIES 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

FIRSTENERGY SOLUTIONS CORP.'S
APPLICATION FOR REHEARING OF THE JULY 2, 2012 OPINION AND ORDER

Pursuant to R.C. § 4903.10 and O.A.C. 4901-1-35, FirstEnergy Solutions Corp. ("FES") seeks rehearing of the Commission's July 2, 2012 Opinion and Order (the "Order") on the following grounds:

1. The Order is unlawful and unreasonable because it sets rates for capacity contrary to PJM's Reliability Assurance Agreement approved by the Federal Energy Regulatory Commission.

2. The Order is unlawful and unreasonable because it sets capacity rates based on the Commission's rate-setting authority under Revised Code Chapter 4909 without following the requirements of that Chapter for establishing rates.

3. The Order is unreasonable because it fails to establish that any charge for the recovery of deferred capacity costs should be nonbypassable.

4. The Order is unreasonable because it fails to establish that any charge for the recovery of deferred capacity costs should terminate upon the establishment of corporate separation by Ohio Power Company (specifically, upon the transfer of that company's generation assets to its affiliate AEP Generation Resources, Inc.).

A memorandum in support of this Application is attached hereto and made a part hereof.

Respectfully submitted,

s/ Mark A. Hayden

Mark A. Hayden (0081077)
FIRSTENERGY SERVICE COMPANY
76 South Main Street
Akron, OH 44308
(330) 761-7735
(330) 384-3875 (fax)
haydenm@firstenergycorp.com

James F. Lang (0059668)
Laura C. McBride (0080059)
N. Trevor Alexander (0080713)
CALFEE, HALTER & GRISWOLD LLP
1405 East Sixth Street
Cleveland, OH 44114
(216) 622-8200
(216) 241-0816 (fax)
jlang@calfee.com
lmcbride@calfee.com
talexander@calfee.com

David A. Kutik (0006418)
Allison E. Haedt (0082243)
JONES DAY
901 Lakeside Avenue
Cleveland, OH 44114
(216) 586-3939
(216) 579-0212 (fax)
dakutik@jonesday.com
aehaedt@jonesday.com

Attorneys for FirstEnergy Solutions Corp.

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MEMORANDUM IN SUPPORT OF FIRSTENERGY SOLUTIONS CORP.'S APPLICATION FOR REHEARING OF THE JULY 2, 2012 OPINION AND ORDER

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I. INTRODUCTION

The Commission's July 2, 2012 Opinion and Order (the "Order") took an important first step in promoting the competitive market for electric generation service required by Ohio law. By requiring Ohio Power Company ("AEP Ohio") to charge competitive retail electric service ("CRES") providers the applicable market price for capacity, AEP Ohio's customers will have better access to the benefits provided by the competitive market. However, certain aspects of the Order should be changed or clarified to protect competition in AEP Ohio's territory and to bring the Order into compliance with federal and state law.

In particular, the Commission erred by relying upon its "traditional ratemaking authority" generally and R.C. Chapter 4909 specifically to determine that AEP Ohio should be allowed to recover its full embedded costs. The Commission's reliance on Chapter 4909 as the basis on which to price AEP Ohio's self-determined monopoly for capacity is inappropriate – substantively and procedurally. The Order wholly ignores the Reliability Assurance Agreement ("RAA"), which is the basis for the Commission's authority to establish a state compensation mechanism. The Federal Energy Regulatory Commission ("FERC"), in approving the Reliability Pricing Model ("RPM") established by the RAA, rejected claims that setting capacity rates should be based on a supplier's full embedded costs. Instead, the FERC determined that the establishment of capacity rates based on a competitive market and *avoidable* costs would result in lower prices for customers through the efficiencies that market mechanisms require suppliers in the market to adopt. The FERC also determined that the RPM would provide transparent pricing sufficient to attract investment and maintain reliable electric service. Given that the concept of embedded cost recovery through capacity rates is utterly antithetical to the RPM – indeed, it directly undermines the very structure of the RPM – the Commission's Order violates the RAA and is unlawful.

In authorizing embedded cost recovery, as opposed to limiting AEP Ohio to market pricing or PJM's established avoidable cost recovery, the Order approves compensation for a product that is not the "FRR capacity obligation" product described in the RAA.[1] Under cost-of-service regulation traditionally used in Ohio, the "capacity" product is defined by reference to fixed generation costs.[2] But this traditional cost-of-service "capacity" product is not the "FRR capacity obligation" for which compensation is due under the RAA. Under the RAA, the FRR capacity obligation exists for the sole purpose of ensuring reliability.[3] The RPM and the RAA set the value of capacity at the level required to ensure reliability – not to recover full embedded costs.[4] Indeed, to the extent pricing of capacity under the RAA requires reference to a capacity supplier's costs, only avoidable costs are relevant.[5] Thus, at most, AEP Ohio's "cost-based" recovery must be based on avoidable costs.

Even if Chapter 4909's traditional ratemaking procedures – that are *de facto* only applicable to utility distribution charges – were appropriate, Chapter 4909 requires certain procedures that were not followed here. Accordingly, Chapter 4909 cannot form the basis for guaranteeing AEP Ohio full embedded cost recovery for capacity. Thus, the Order should be

[1] *See* RAA Schedule 8.1, Section D.8 (providing that, in the case of load that switches to a CRES provider, where the PUCO requires switching customers or the CRES provider to compensate AEP Ohio for its FRR capacity obligations, such state compensation mechanism will prevail).

[2] When the capacity product is based on fixed generation costs, any and all energy needed is provided at no more than variable cost, not at market. *See* Tr. Vol. II, pp. 249-50 (AEP Ohio witness Pearce describing AEP contracts pricing capacity based on embedded costs with energy priced at variable cost). *See also* Tr. Vol. II, pp. 252-53 (AEP Ohio witness Pearce admitting that cost template he relied upon has never been approved by FERC for wholesale customers taking only capacity and has never been used to develop a rate for a customer that takes only capacity); Tr. Vol. II, p. 254 (AEP Ohio witness Pearce agreeing that energy credit calculated under template has never been approved by FERC for customers taking only capacity).

[3] Tr. Vol. VIII, pp. 1600-03.

[4] Tr. Vol. VIII, pp. 1600-01.

[5] FES Exh. 101, pp. 16-17, 28-40.

reversed to the extent it authorizes AEP Ohio to recover excess "costs" above market prices (and above AEP Ohio's avoidable costs).

If the Commission nevertheless implements a deferral mechanism to recover AEP Ohio's embedded costs, the Commission should clarify that the above-market guarantee/subsidy contained in the deferral is only in place until the date on which AEP Ohio completes corporate separation – or no later than January 1, 2014, the date on which AEP Ohio has asserted it can complete corporate separation. After AEP Ohio's corporate separation, it will have no generation assets on which to base recovery of its capacity "costs." AEP Ohio's separate competitive affiliate, AEP Generation Resources, Inc. ("AEP GenCo"), has no right to above-market cost recovery under Chapter 4909 or any other provision of Ohio law, and such cost recovery would be a prohibited cross-subsidy. Further, the Commission should clarify the Order so that, to the extent "cost" recovery is maintained, the deferred excess costs are recovered from all customers on a nonbypassable basis. The excess cost recovery serves only as a subsidy to AEP Ohio and, therefore, all of AEP Ohio's customers should be required to pay for it.

II. ARGUMENT

A. The Order Unlawfully And Unreasonably Establishes A State Compensation Mechanism Based On Embedded Costs.

In the Order, the Commission established a cost-based state compensation mechanism based on AEP Ohio's purported full embedded costs.[6] While the Order properly directed AEP Ohio to charge CRES providers RPM prices for capacity, the Commission also authorized AEP Ohio to defer "incurred capacity costs not recovered from CRES billings during the ESP period

[6] Order, p. 22. The Commission's $188.88/MW-day price represents a modification of Staff's calculation, which, in turn, is based on AEP Ohio's purported embedded cost calculation. *See* Order, pp. 33-35. The Commission's (and Staff's) modifications of AEP Ohio's proposed calculation reflect, for the most part, the implementation of an energy credit and other adjustments that do not affect the nature of the cost calculation.

to the extent that the total incurred capacity costs do not exceed" $188.88/MW/day – in other words, the difference between the RPM prices and $188.88/MW-day.[7] In guaranteeing AEP Ohio the right to recover its full embedded costs in the amount of $188.88/MW-day, the Order is unreasonable and unlawful. The recovery of embedded costs through capacity prices is improper based on PJM's tariff and Ohio law and policy.

1. The only possible costs that could be considered for pricing capacity in PJM's territory are *avoidable* costs, not embedded costs.

As the Commission's Order properly reflects, the RAA and Attachment DD of PJM's Open Access Transmission Tariff ("OATT"), as approved by the FERC, determines capacity prices in PJM's territory. In particular, the RAA addresses compensation for "FRR capacity obligations," with the default set at PJM RTO market prices.[8] Therefore, the state compensation mechanism must be established in accordance with the terms of the RAA. While recognizing that the establishment of a capacity charge arises from the RAA, the Commission fails to consider the RAA and instead relies on the Commission's "traditional ratemaking authority" and R.C. Chapter 4909 to determine that the state compensation mechanism for AEP Ohio's FRR capacity obligations should be based on its full embedded costs. By determining that the state compensation mechanism provided for under the RAA should be based on a capacity supplier's embedded costs, the Commission's Order establishes an unlawful rate.

The RAA and Attachment DD of the PJM OATT implement the RPM. According to FERC, "RPM is based on the premise that competition in properly designed markets will produce just and reasonable prices."[9] FERC determined that, with RPM, customer costs will be

[7] Order, pp. 23, 33.

[8] RAA Schedule 8.1, Section D.8.

[9] FES Ex. 118 (*In re PJM Interconnection, LLC,* 121 FERC ¶ 61,173 at ¶3, quoting *In re PJM Interconnection, LLC*, 119 FERC ¶ 61,318 at ¶ 191)).

lower and reliability will be greater.[10] The purpose of RPM is to replicate a competitive market.[11] In approving the tariff revisions necessary to implement RPM, FERC explained the benefits of RPM's competitive orientation:

> Such competitive market mechanisms provide important economic advantages to electricity customers in comparison to 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 then keeps prices as low as possible. While an efficient seller may, at times, receive revenues that are above its average total costs, the revenues to an inefficient seller may be below its average total costs and it may be driven out of business. This market result benefits customers because over time it results in an industry with more efficient sellers and lower prices.[12]

In determining that RPM-produced rates were just and reasonable, FERC expressly rejected embedded cost recovery as the standard by which the reasonableness of market-based rates should be judged.[13]

The RAA provides the Fixed Resource Requirement ("FRR") as an alternative to participation in PJM's capacity auctions for capacity suppliers. The FRR permits Load Serving Entities ("LSEs") to "provide capacity though their own generation or other means (*e.g.,* through contracts) sufficient to meet PJM's reserve margin."[14] Once the FRR entity's FRR plan is

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[10] *Id.*

[11] *Id.* at ¶ 13, n.20 and ¶ 24.

[12] *Id.* at ¶ 32, quoting *In re PJM Interconnection, LLC*, 117 FERC ¶ 61,331 at ¶ 141.

[13] *Id.* at ¶¶ 31-32.

[14] *In re PJM Interconnection, LLC,* 119 FERC ¶ 61,318 at ¶ 3. As explained by the FERC:

> An entity that chooses the FRR alternative submits an FRR capacity plan to PJM, a long-term plan for the commitment of capacity resources to satisfy the entity's capacity obligations. The area covered by the plan is: (i) the service territory of the investor-owned utility; (ii) the service territory of a public power entity or electric cooperative; or (iii) a separately identifiable geographic

approved, the obligation of that entity with regard to the supply of capacity is little different than any other capacity supplier in PJM.[15] The only difference between an FRR entity and another capacity supplier is that the former commits capacity to meet a certain PJM-established target while the latter commits all of the capacity it owns to the extent that such capacity cleared the RPM auctions.[16] Because the FRR entity opts not to participate in the RPM auctions, the RAA sets forth how that entity should be paid for its capacity obligations. In sum, the RAA provides, in a specific priority, three possible methods to determine those rates:

> 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.[17]

Thus, the default price for an FRR entity's capacity obligations is the RPM auction-based price. The FRR entity's capacity rate may otherwise be determined through a state compensation mechanism, as determined by a state regulatory commission. In the absence of a state compensation mechanism, the FRR entity may apply to FERC to set a rate under Section 205 of

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> area that is bounded by wholesale metering, or similar appropriate mulit-site aggregate metering, for which the FRR entity has or assumes the obligation to provide capacity for all load (including load growth) within such area.

In re PJM Interconnection, LLC, 135 FERC ¶ 61,228 at ¶ 4, n.8, citing RAA at Schedule 8.1.

[15] Tr. Vol. VIII, pp. 1628-29.

[16] *Id.*

[17] RAA, Schedule 8.1.

the Federal Power Act. Notably, FERC has determined, "RPM, *including the Fixed Resource Requirement,* establishes the just and reasonable rate in order to ensure that PJM is able to meet the applicable resource requirements."[18]

A state commission's discretion to set a state compensation mechanism under the RAA is limited by the language and purpose of the RAA and, to the extent that a state compensation mechanism is based on cost, on the relevant provisions in Section 6.6 and 6.8 of Attachment DD that establish that an Avoided Cost Rate is the appropriate measure of cost for purposes of the RPM capacity product. In the Order, the Commission failed to consider the language, structure and purpose of the RPM. FES witness Stoddard was one of the drafters of the RAA and related tariff provisions, including Attachment DD of the PJM OATT.[19] He was also one of four individuals chosen to submit an affidavit in support of the approval of the RPM by FERC as part of the settlement process that produced that agreement.[20] As is relevant here, his testimony, which is unrebutted, explained the purpose and context of the RAA and its state compensation mechanism, and that the purpose and context is contrary to allowing an FRR entity to price PJM capacity at embedded costs:

> Allowing an FRR Entity to recoup its embedded costs from other LSEs in its zone would deviate from the theory and practice underlying the entire RPM design. It was understood that any state compensation mechanism would be part of a larger regulatory framework in a state to implement competitive retail access. The state compensation mechanism should, therefore, operate so as not to discriminate against retail suppliers or to discourage competition. But if competitive retail electric suppliers had to pay embedded costs for capacity to the FRR Entity, while also having

[18] FES Ex. 118 at ¶ 49 (emphasis added).

[19] FES Ex. 1, Direct Testimony of Robert B. Stoddard ("Stoddard Direct"), p. 1-2.

[20] *Id.*

> to pay market prices for *energy*, these suppliers would have been at a sharp and discriminatory cost disadvantage to the utility.[21]

Mr. Stoddard further explained, again without rebuttal, the discriminatory disadvantage that competitive suppliers would suffer if the state compensation mechanism allowed the recovery of embedded costs:

> [F]aced with the choice of paying AEP Ohio a retail rate equal to the sum of the embedded capacity cost rate plus *at-cost* generation, or paying a CRES provider the same AEP Ohio embedded cost rate plus *market* generation, a customer's preference would be to be a retail customer of AEP Ohio.[22]

Indeed, as Mr. Stoddard also observed, also without rebuttal, the carefully crafted structure set out in the RAA and the PJM tariff provisions would be eviscerated if a state compensation mechanism were based on embedded costs:

> [M]y view of it as we wrote this [i.e., the RAA], we were talking just about avoidable costs. We were trying to set up a market structure that didn't turn the FRR into some way that a regular entity could get a really big number, whereas if they were going to be in the RPM, they would do poorly.
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> What we would have done then is create an exception that swallowed the rule. Everyone that could have taken that option would have chosen to get some high value. The point of this market is to be comprehensive. The point of the FRR was to allow a very limited carve-out for firms that had regulatory reasons and state reasons to seek a different structure.[23]

Importantly, the RAA never uses the term "embedded cost."[24] As Mr. Stoddard observed, the only "costs" discussed or referred to in the RAA are *avoidable* costs.[25] Under the

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[21] Stoddard Direct, p. 17.

[22] Stoddard Direct, p. 18.

[23] Tr. Vol. VIII, p. 1647-48.

[24] Stoddard Direct, p. 16. The Order also notes AEP Ohio's argument that the RAA allows an FRR entity to change the basis for capacity pricing to a cost-based method at any time. Order, p. 14. There is no basis for that argument. In fact, the RAA clearly states – and the FERC recently confirmed – that an FRR entity such as AEP Ohio only has the right to *ask* for approval of a cost-based rate if there is no state

RAA, capacity price bids offered into the RPM auctions 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").[26] Offers based on the ACR replicate the bidding behavior that would be expected in a competitive environment.[27] In a competitive market – and in the absence of market power – 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.[28] Thus, suppliers are assured the ability to recover the costs necessary to produce their product (in this case, FRR capacity) and remain competitive in the market while promoting the lowest price for customers.[29] Compensation for FRR capacity obligations based on avoidable costs is the only cost-based compensation consistent with the RAA.

A construct for RPM prices based on avoidable costs would provide a significant and sufficient positive cash flow for AEP Ohio. Mr. Stoddard calculated AEP Ohio's ACR using data and models developed by Charles River Associates in accordance with the formula established by PJM's tariff.[30] Mr. Stoddard's unrebutted calculation showed that if AEP Ohio's entire FRR portfolio of generation assets was considered, AEP Ohio has a net ACR of negative $51.05/MW-day.[31] Thus, even if AEP Ohio's capacity was priced at $1/MW-day, AEP Ohio's

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compensation mechanism in place. *See American Electric Power Serv. Corp.*, 134 FERC ¶ 61,039 (2011) at ¶¶ 1, 8-10, 12-13 (emphasis added).

[25] Stoddard Direct, p. 16. AEP Ohio's witness Horton agreed that the term "embedded cost" was a concept that was not to be found in the RPM tariffs or the RAA. Tr. Vol. II, p. 386-87.

[26] Stoddard Direct, p. 12, citing PJM OATT Section 6.8, Attachment DD.

[27] Stoddard Direct, p. 12.

[28] Stoddard Direct, p. 12.

[29] *See* Stoddard Direct, p. 13.

[30] Stoddard Direct, p. 30.

[31] Stoddard Direct, p. 34.

operating revenues would exceed its operating costs.[32] But RPM prices are higher; the average delivered RPM price for the three planning years at issue is $69.22/MW-day.[33] Accordingly, RPM prices will allow AEP Ohio to recover its avoidable costs and more over the course of the next three planning years; "embedded cost" recovery as authorized by the Commission would provide an additional, excessive revenue stream not available to other suppliers.[34]

Mr. Stoddard was the only witness who provided evidence of the value of AEP Ohio's FRR capacity obligations as set out in the RAA. AEP Ohio's and Staff's witnesses valued AEP Ohio's fixed generation assets by reference to Ohio's traditional cost-of-service principles. Yet AEP Ohio's FRR capacity obligations are not defined by the cost of its fixed generation assets. Instead, as provided by the controlling federal tariff, FRR capacity obligations are valued based on PJM's reliability requirements with the assumption that FRR entities are receiving market pricing for energy. This can be done either on an avoidable cost basis or a market basis, but not on a full embedded cost basis.

The Commission partially justifies its holding by stating that RPM prices are "substantially below all estimates provided by the parties regarding AEP-Ohio's cost of capacity."[35] This is the wrong comparison. RPM prices are based on *avoidable* costs, whereas the cost calculations cited by the Commission reflect different estimates of *full embedded* costs. As discussed above, avoidable costs are lower than full embedded costs. But RPM auction-

[32] Stoddard Direct, p. 35.

[33] Direct Testimony of Jonathan A. Lesser, p. 36.

[34] Indeed, the FERC recently questioned AEP's request for a cost-based capacity pricing formula. That request was based on the same formula rates proposed by AEP Ohio in this proceeding, which form the basis for the Commission's Order and its modifications to Staff's calculation. The FERC noted that its "preliminary analysis in this proceeding indicates that the proposed rate may be substantially excessive." FERC Docket No. ER12-1173-000, Order Accepting Formula Rate Proposal And Establishing Hearing And Settlement Judge Procedures, Apr. 30, 2012, at ¶ 21.

[35] Order, pp. 22-23.

based prices are substantially higher than AEP Ohio's *avoidable* costs. Accordingly, AEP Ohio's *avoidable* costs would be fully recovered using RPM auction-based prices. Because RPM auction-based prices are higher than AEP Ohio's avoidable costs, AEP Ohio will recover positive cash returns for fulfilling its FRR capacity obligations.[36] These returns will contribute to the recovery (though not the total recovery) of AEP Ohio's other costs.

The Commission further justifies its decision based on the alleged return on equity that would result from a RPM auction-based rate.[37] But considerations of a return on equity are not appropriate in this context. As Mr. Stoddard noted, in a competitive market, no competitor is guaranteed any rate of return.[38] In its review of RPM pricing, FERC expressly observed that prices established under the RAA may result in having "revenues to an inefficient seller . . . below its average total costs" and that such a price may result in that seller being "driven out of business."[39]

Moreover, AEP Ohio will not own generation assets as of January 1, 2014. Therefore, any concerns about any vague future "financial harm" relating to the provision of capacity are even less relevant. There is no probative evidence of any financial harm, and AEP Ohio has not presented evidence that meets the standards required for emergency rate relief or other protections.[40] As such, there is no basis in law or reason for the Order's guaranteed excess cost recovery or AEP Ohio's insulation from the RPM market prices for capacity.

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[36] Stoddard Direct, pp. 39-40.

[37] Order, p. 23.

[38] Tr. Vol. VIII, pp. 1639-40.

[39] FES Ex. 118 (121 FERC ¶ 61,173, FERC Docket No. ER05-1410-005 and EL05-148-005, Order Denying Rehearing, Nov. 15, 2007) at ¶ 32 *quoting* 117 FERC ¶ 61,331, Dec. 22., 2006 Order, at ¶ 141.

[40] When corrected, Mr. Allen's analysis reflects that AEP Ohio's proposed capacity charge would allow it to earn an ROE of 13.4% in 2012 and 13.7% in 2013. FES Ex. 122 (Scenario 2). *See In re Akron Thermal, Ltd. Partnership*, Case No. 00-2260-HT-AEM, Opinion and Order at p. 3 (Jan. 25, 2001)

In addition, the Commission in its Order loses sight of the purpose of the state compensation mechanism under the RAA – to foster retail choice. In fact, the Order does the exact opposite. The Commission's Order places AEP Ohio at a competitive advantage relative to all other capacity suppliers in PJM. While existing PJM resources may not include embedded costs in their capacity price bids, the Order would allow AEP Ohio to recover these costs.[41] In fact, the Order's authorization to allow AEP Ohio to recover the equivalent of $188.88/MW-day for its capacity would put AEP Ohio in a unique position: AEP Ohio would be the only capacity supplier in PJM that was guaranteed to recover its full embedded costs for generation.[42] As demonstrated above, given a choice between the embedded cost rate for capacity and energy and the embedded cost rate for capacity and a market rate for energy, customers would choose the former – which only AEP Ohio can provide.

AEP Ohio's FRR status cannot justify treating AEP Ohio differently from any other generation supplier or especially allowing AEP Ohio to recover embedded costs. As noted, there is no material difference between the FRR election and all other generators' participation in PJM's base residual auction.[43] There also is no need for excess cost recovery to encourage AEP Ohio's generation investments because "AEP Ohio is not planning to build significant new generation prior to 2015"[44] and because RPM is working well to incentivize appropriate generation investments.[45] There is no support for the Order's authorization of embedded cost

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(requiring clear and convincing evidence that, absent such extraordinary emergency relief, the utility will be financially imperiled or its ability to render service will be impaired).

[41] Stoddard Direct, p. 16.

[42] Tr. Vol. V, p. 859; Stoddard Direct, p. 19.

[43] Tr. Vol. VIII, pp. 1606-08.

[44] AEP Ohio Brief, p. 22.

[45] IEU Ex. 125, p. 1, 6. Further, AEP Ohio witness Frank Graves testified that RPM has done a good job of incentivizing the construction of new capacity and that PJM (including the AEP Ohio zone) is currently

recovery in excess of RPM prices. Accordingly, the Order's authority for AEP Ohio's deferred recovery of full embedded costs for capacity provided to CRES providers is unlawful, unreasonable, and unsupported.

2. The Order's application of Chapter 4909 to the calculation of AEP Ohio's embedded cost-based rate is unlawful and unreasonable.

Instead of limiting AEP Ohio's cost recovery to RPM prices consistent with the RAA, the Order states that Revised Code Chapters 4905 and 4909 "require that the Commission use traditional rate base/rate of return regulation to approve rates that are based on cost . . . ."[46] The Commission then applies the factors and analyses used under Chapter 4909 to establish a purportedly "just and reasonable" cost-based rate of $188.88/MW-day for AEP Ohio's capacity provided to CRES providers.[47] As set forth above, excess cost-based recovery is inappropriate for numerous reasons. However, even if cost-based recovery were appropriate, the Order's establishment of a rate under Chapter 4909 is unlawful because AEP Ohio did not fulfill the requirements of Chapter 4909.

Chapter 4909 sets forth the procedures and parameters for setting a public utility's rates.[48] "While the General Assembly has delegated authority to the [Commission] to set just and reasonable rates for public utilities under its jurisdiction, it has done so by providing a detailed, comprehensive and, as construed by this court, mandatory ratemaking formula under R.C. 4909.15."[49] Thus, in setting rates, "the statutes of this state and the decisions of this court

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long on capacity – with 13 GW of excess capacity currently and an additional 5-9 GW expected in the next few years. Tr. Vol. V, pp. 869-71; *see also* Stoddard Direct, Ex. RBS-6, p. 1.

[46] Order, p. 22.

[47] *See* Order, pp. 33-36.

[48] *See* R.C. Ch. 4909.

[49] *Columbus So. Power Co. v. Pub. Util. Comm.*, 67 Ohio St.3d 535, 535 (1993) (citing *Gen. Motors Corp. v. Pub. Util. Comm.*, 47 Ohio St.2d 58 (1976)) (emphasis added).

indicate that the [Commission] must" adhere to the requirements of Chapter 4909.[50] For example, when establishing a cost-based rate, the Commission must determine, among other things:

- the value of the utility's used and useful property as of a date certain;
- a reasonable rate of return;
- the dollar return applying the reasonable rate of return to the valuation of the property; and
- the cost of the utility in providing service during a test period.[51]

The Commission made no determinations in this case about the value of AEP Ohio's property, a reasonable rate of return or a dollar rate of return. Nothing in the record in this proceeding established such a test period, and certainly not a test period that conforms to the time limits set forth in the statute.[52] Given the absence of a test period, there was no determination made about the cost of AEP Ohio in such a period.

Chapter 4909 has other procedural requirements. For example, R.C. §§ 4909.18 and 4909.19 mandate that certain notices be given. No such notices were provided here. Further, the utility applying for an increase in rates (such as was requested here) also must submit certain information in connection with its application, including:

> (A) A report of its property used and useful . . . in rendering the service referred to in such application;

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[50] *City of Cleveland v. Pub. Util. Comm.*, 164 Ohio St. 442, 443 (1956) (citing requirements of R.C. §§ 4909.04, 4909.05, and 4909.15) (emphasis added).

[51] R.C. § 4909.15(C)(1) ("Except as provided in division (D) of this section [for natural gas companies], the revenues and expenses of the utility shall be determined during a test period.").

[52] R.C. § 4909.15(C)(1) ("The utility may propose a test period for this determination that is any twelve-month period beginning not more than six months prior to the date the application is filed and ending not more than nine months subsequent to that date.").

> (B) A complete operating statement of its last fiscal year, showing in detail all its receipts, revenues, and incomes from all sources, all of its operating costs and other expenditures . . .; [and]
>
> (D) A statement of financial condition summarizing assets, liabilities, and net worth . . . .[53]

None of this required information was submitted by AEP Ohio in connection with its application (or otherwise).

If the Commission seeks to establish a cost-based rate for a generation service based on "traditional rate regulation," then the procedures and requirements of Chapter 4909 must be followed. This proceeding has adhered to few, if any, of those requirements. As such, the Order's authorization for AEP Ohio to recover, via a deferral, the equivalent of the purported cost-based rate of $188.88/MW-day for capacity provided to CRES providers must be reversed.

B. Clarification Of The Anticipated Deferral Recovery Mechanism Is Necessary.

1. The deferral recovery mechanism must be nonbypassable.

The Commission's Order recognized that "RPM-based capacity pricing will further the development of competition in the market, which is one of our primary objectives in this proceeding."[54] The Commission further noted that "RPM-based capacity pricing is . . . a reasonable means of promoting shopping in AEP-Ohio's service territory and advancing the state policy objectives of Section 4928.02, Revised Code, which the Commission is required to effectuate pursuant to Section 4928.06(A)."[55] The Order, however, did not specify any terms or conditions of the mechanism through which the deferred amount would be recovered by AEP Ohio. As set forth above, the Order's authorization for AEP Ohio to recover its full embedded costs is unlawful and unreasonable. If the Commission declines to eliminate that improper

[53] R.C. § 4909.18.

[54] Order, p. 23.

[55] Order, p. 23.

portion of the state compensation mechanism, the Commission should confirm that the deferred amount must be recovered on a nonbypassable basis.

A nonbypassable recovery mechanism is necessary to ensure that the Commission's goals of promoting competition through the deferral are met and that the charges are distributed in the most equitable and practical way. A mechanism that imposes the deferred amount on shopping customers only will eliminate the benefits of RPM prices in promoting competition and would render the use of RPM prices meaningless. Charging shopping customers RPM prices plus the difference between RPM prices and AEP Ohio's full embedded cost of $188.88/MW-day is essentially the same as charging shopping customers $188.88/MW-day now. The fact that the deferred amount might be recovered at some point in the future does not serve as a benefit if the recovery is sought only from shopping customers. To the contrary, such a mechanism would only jeopardize the competitive market that is just getting off the ground in AEP Ohio's service territory. Suppliers may avoid entering the market if a future discriminatory charge is looming. Charging the deferred amount on a bypassable basis also makes no sense. If the charge were bypassable, the deferred amount would be charged only to customers that are not shopping. At the same time, charging the recovery of the deferred amount to either shopping or nonshopping customers is impractical. Customers who are shopping now may not be shopping when the recovery of the deferral begins – and vice-versa. It would be nearly impossible (and, in any event, very costly) to assess the deferred amount to only those customers who shopped or who didn't shop when one of the benefits of a competitive market is the option to select different product offerings, including the SSO. The only equitable method to implement the recovery of the deferred amount is to apply the charge evenly to all of AEP Ohio's customers on a nonbypassable basis.

The deferral recovery mechanism also should be nonbypassable and paid by all of AEP Ohio's customers because the above-market "costs" recovered through the deferral were authorized to benefit AEP Ohio. The Commission's Order notes that it authorized AEP Ohio to recover its full embedded costs because RPM prices would provide AEP Ohio with "an unusually low return on equity" and would be "insufficient to yield reasonable compensation" to AEP Ohio.[56] Thus, the impact of the additional cost recovery is primarily directed at providing a financial subsidy to AEP Ohio, as a whole. Accordingly, all of AEP Ohio's customers should pay for the deferred amount.

2. The deferral recovery mechanism must recognize AEP Ohio's impending corporate separation.

The Order directs that the state compensation mechanism "shall remain in effect until AEP-Ohio's transition to full participation in the RPM market is complete and the Company is no longer subject to its FRR capacity obligations, which is expected to occur on or before June 1, 2015, or until otherwise directed by the Commission."[57] The Order does not specify how the state compensation mechanism will be implemented (if at all) after AEP Ohio's corporate separation. As of January 1, 2014, AEP Ohio expects to have transferred its generation assets to AEP GenCo, a separate competitive affiliate.[58] If the Order is construed to apply to the capacity prices charged by AEP GenCo after corporate separation, it would represent an improper subsidy to a competitive, unregulated supplier.

Indeed, the Commission drew on its authority under Revised Code Chapters 4905 and 4909 for its jurisdiction to establish a state compensation mechanism and for the methodology

[56] Order, p. 23.

[57] Order, p. 24.

[58] Tr. Vol. I, p. 32, 36.

pursuant to which AEP Ohio's "costs" should be calculated.[59] Those chapters describe the Commission's general jurisdiction to regulate and oversee public utilities in the state and to fix just and reasonable rates for such public utilities.[60] But AEP GenCo will not be a public utility and Chapter 4909 cannot be said to apply to AEP GenCo – directly or indirectly through AEP Ohio – because the generation assets (or "property") on which the $188.88/MW-day cost-based price is based will no longer be owned by AEP Ohio – and no longer be subject to the Commission's jurisdiction.[61]

Because AEP Ohio would have no capacity or generation costs after its corporate separation, the recovered "costs" incurred after corporate separation would be paid to AEP GenCo. Such a cross-subsidy is antithetical to Ohio's (or any) competitive market for generation service.[62] The cross-subsidy that would result from the state compensation mechanism's application to AEP GenCo also makes no economic sense and would only harm customers. As FES witness Dr. Lesser explained, "there is no rational economic basis as to why AEP Ohio would agree to purchase capacity from [AEP GenCo] 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 GenCo] at an above-market price would be a cross-subsidy and a form of price discrimination."[63]

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[59] *See* Order, pp. 12 ("We affirm our prior finding that Sections 4905.04, 4905.05, and 4905.06, Revised Code, grant the Commission the necessary statutory authority to establish a state compensation mechanism."), 22 (citing Chapters 4905 and 4909 as authority for a cost-based state compensation mechanism), and 34 (referencing costs included in other *distribution* rate proceedings), 35 (citing R.C. § 4909.15 for costs included or excluded from rate calculation).

[60] *See, e.g.,* R.C. §§ 4905.04, 4905.05, 4905.06, 4909.15.

[61] *See* R.C. § 4909.15.

[62] 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).

[63] Lesser Direct, p. 15.

Moreover, the affiliate transaction would be subject to FERC oversight and likely would not be approved.[64]

Accordingly, if the Order is not reversed such that RPM prices form the basis for all of AEP Ohio's cost recovery for capacity, the Order should be modified to confirm that the state compensation mechanism will be in place until January 1, 2014, at which time and upon AEP Ohio's corporate separation, AEP GenCo will be authorized to charge the same RPM RTO price that is charged in all other unconstrained parts of PJM.

III. CONCLUSION

For the foregoing reasons, the Commission should grant FES' Application for Rehearing to correct the errors described herein and to clarify the issues raised herein.

Respectfully submitted,

s/ Mark A. Hayden

Mark A. Hayden (0081077)
FIRSTENERGY SERVICE COMPANY
76 South Main Street
Akron, OH 44308
(330) 761-7735
(330) 384-3875 (fax)
haydenm@firstenergycorp.com

James F. Lang (0059668)
Laura C. McBride (0080059)
N. Trevor Alexander (0080713)
CALFEE, HALTER & GRISWOLD LLP
1405 East Sixth Street
Cleveland, OH 44114
(216) 622-8200
(216) 241-0816 (fax)
jlang@calfee.com
lmcbride@calfee.com
talexander@calfee.com

[64] *Duke Energy Indiana Inc.*, 136 FERC P 61001, 2011 WL 2644369, p. *2 (FERC 2011); *Boston Edison Company Re: Edgar Electric Energy Company*, 55 FERC P 61382, 1991 WL 266200, *8 (FERC 1991).

David A. Kutik (0006418)
Allison E. Haedt (0082243)
JONES DAY
901 Lakeside Avenue
Cleveland, OH 44114
(216) 586-3939
(216) 579-0212 (fax)
dakutik@jonesday.com
aehaedt@jonesday.com

Attorneys for FirstEnergy Solutions Corp.

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing *FirstEnergy Solutions Corp.'s Application for Rehearing of the July 2, 2012 Opinion and Order* and the *Memorandum in Support* thereof were served this 1st day of August, 2012, via e-mail upon the parties below.

s/ Laura C. McBride
One of the Attorneys for FirstEnergy Solutions Corp.

Steven T. Nourse
Matthew J. Satterwhite
Yazen Alami
American Electric Power Corp.
1 Riverside Plaza, 29th Floor
Columbus, Ohio 43215
stnourse@aep.com
mjsatterwhite@aep.com
yalami@aep.com

Jeanne W. Kingery
Amy Spiller
139 East Fourth Street
1303-Main
Cincinnati, Ohio 45202
jeanne.kingery@duke-energy.com
amy.spiller@duke-energy.com

Daniel R. Conway
Porter Wright Morris & Arthur
41 South High Street
Columbus, Ohio 43215
dconway@porterwright.com

David F. Boehm
Michael L. Kurtz
Boehm, Kurtz & Lowry
36 East Seventh Street. Suite 1510
Cincinnati, Ohio 45202
dboehm@bkllawfirm.com
mkurtz@bkllawfirm.com

Cynthia Fonner Brady
David I. Fein
550 W. Washington Street, Suite 300
Chicago, IL 60661
cynthia.a.fonner@constellation.com
david.fein@constellation.com

Kyle L. Kern
Melissa R. Yost
Office of the Ohio Consumers' Counsel
10 West Broad Street, Suite 1800
Columbus, Ohio 43215-3485
kern@occ.state.oh.us
yost@occ.state.oh.us

Richard L. Sites
Ohio Hospital Association
155 East Broad Street, 15th Floor
Columbus, Ohio 43215-3620
ricks@ohanet.org

Thomas J. O'Brien
Bricker & Eckler
100 South Third Street
Columbus, Ohio 43215-4291
tobrien@bricker.com

Shannon Fisk
2 North Riverside Plaza, Suite 2250
Chicago, IL 60606
sfisk@nrdc.org

Jay E. Jadwin
American Electric Power Service Corporation
1 Riverside Plaza, 29th Floor
Columbus, Ohio 43215
jejadwin@aep.com

Mark S. Yurick
Zachary D. Kravitz
Taft Stettinius & Hollister LLP
65 East State Street, Suite 1000
Columbus, Ohio 43215
myurick@taftlaw.com
zkravitz@taftlaw.com

Terrence O'Donnell
Christopher Montgomery
Bricker & Eckler LLP
100 South Third Street
Columbus, Ohio 43215-4291
todonnell@bricker.com
cmontgomcry@bricker.com

Jesse A. Rodriguez
Exelon Generation Company, LLC
300 Exelon Way
Kennett Square, Pennsylvania 19348
jesse.rodriguez@exeloncorp.com

Glen Thomas
1060 First Avenue, Ste. 400
King of Prussia, Pennsylvania 19406
gthomas@gtpowergroup.com

Henry W. Eckhart
2100 Chambers Road, Suite 106
Columbus, Ohio 43212
henryeckhart@aol.com

C. Todd Jones
Christopher L. Miller
Gregory H. Dunn
Asim Z. Haque
Ice Miller
250 West Street
Columbus, Ohio 43215
christopher.miller@icemiller.com
asim.haque@icemiller.com
gregory.dunn@icemiller.com

Michael R. Smalz
Joseph V. Maskovyak
Ohio Poverty Law Center
555 Buttles Avenue
Columbus, Ohio 43215
msmalz@ohiopovertylaw.org
jmaskovyak@ohiopovertylaw.org

Lisa G. McAlister
Matthew W. Warnock
Bricker & Eckler LLP
100 South Third Street
Columbus, Ohio 43215-4291
lmcalister@bricker.com
mwarnock@bricker.com

William L. Massey
Covington & Burling, LLP
1201 Pennsylvania Ave., NW
Washington, DC 20004
wmassey@cov.com

Laura Chappelle
4218 Jacob Meadows
Okemos, Michigan 48864
laurac@chappelleconsulting.net

Pamela A. Fox
Law Director
The City of Hilliard, Ohio
pfox@hilliardohio.gov

M. Howard Petricoff
Stephen M. Howard
Michael J. Settineri
Lija Kaleps-Clark; Benita Kahn
Vorys, Sater, Seymour and Pease LLP
52 E. Gay Street
Columbus, Ohio 43215
mhpetricoff@vorys.com
smhoward@vorys.com
mjsettineri@vorys.com
lkalepsclark@vorys.com
bakahn@vorys.com

Sandy Grace
Exelon Business Services Company
101 Constitution Avenue N.W., Suite 400 East
Washington, DC 20001
sandy.grace@exeloncorp.com

Gary A. Jeffries
Dominion Resources Services, Inc.
501 Martindale Street, Suite 400
Pittsburgh, PA 15212-5817
gary.a.jeffries@aol.com

Kenneth P. Kreider
David A. Meyer
Keating Muething & Klekamp PLL
One East Fourth Street, Suite 1400
Cincinnati, Ohio 45202
kpkreider@kmklaw.com
dmeyer@kmklaw.com

Steve W. Chriss
Wal-Mart Stores, Inc.
2001 SE l0th Street
Bentonville, Arkansas 72716
stephen.chriss@wal-mart.com

Holly Rachel Smith
Holly Rachel Smith, PLLC
Hitt Business Center
3803 Rectortown Road
Marshall, Virginia 20115
holly@raysmithlaw.com

Barth E. Royer
Bell & Royer Co., LPA
33 South Grant Avenue
Columbus, Ohio 43215-3927
barthroyer@aol.com

Gregory J. Poulos
EnerNOC, Inc.
101 Federal Street, Suite 1100
Boston, MA 02110
gpoulos@enernoc.com

Werner L. Margard III
John H. Jones
William Wright
Steven Beeler
Assistant Attorneys General
Public Utilities Section
180 East Broad Street, 6th Floor
Columbus, OH 43215
werner.margard@puc.state.oh.us
john.jones@puc.state.oh.us
william.wright@puc.state.oh.us
steven.beeler@puc.state.oh.us

Philip B. Sineneng
Terrance A. Mebane
Carolyn S. Flahive
Thompson Hine LLP
41 S. High Street, Suite 1700
Columbus, Ohio 43215
philip.sineneng@thompsonhine.com
carolyn.flahive@thompsonhine.com
terrance.mebane@thompsonhine.com

Emma F. Hand
Douglas G. Bonner
Keith C. Nusbaum
Clinton A. Vince
SNR Denton US LLP
1301 K Street, NW, Suite 600, East Tower
Washington, DC 20005-3364
emma.hand@snrdenton.com
doug.bonner@snrdenton.com
keith.nusbaum@snrdenton.com
Clinton.vince@snrdenton.com

Samuel C. Randazzo
Joseph E. Oliker
Frank P. Darr
McNees Wallace & Nurick
21 East State Street, 17th Floor
Columbus, Ohio 43215
sam@mwncmh.com
joliker@mwncmh.com
fdarr@mwncmh.com

Colleen L. Mooney
David C. Rinebolt
Ohio Partners for Affordable Energy
231 West Lima Street
Findlay, Ohio 45840
cmooney2@columbus.rr.com
drinebolt@ohiopartners.org

John N. Estes III
Paul F. Wight
Skadden, Arps, Slate, Meagher & Flom LLP
1440 New York Ave., N.W.
Washington, DC 20005
jestes@skadden.com
paul.wight@skadden.com

Trent A. Dougherty
Cathryn Loucas (0073533)
Ohio Environmental Council
1207 Grandview Avenue, Suite 201
Columbus, Ohio 43212-3449
trent@theoeg.org
cathy@theoec.org

Tara C. Santarelli
Environmental Law & Policy Center
1207 Grandview Avenue, Suite 201
Columbus, Ohio 43212
tsantarelli@elpc.org

Joel Malina
Executive Director
COMPLETE Coalition
1317 F Street, NW
Suite 600
Washington, DC 20004
malina@wexlerwalker.com

Christopher J. Allwein
Williams, Allwein and Moser, LLC
1373 Grandview Avenue, Suite 212
Columbus, Ohio 43212
callwein@williamsandmoser.com

David M. Stahl
Arin C. Aragona
Scott C. Solberg
Eimer Stahl Klevorn & Solberg LLP
224 South Michigan Avenue, Suite 1100
Chicago, IL 60604
dstahl@eimerstahl.com
aaragona@eimerstahl.com
ssolberg@eimerstahl.com

Jay L. Kooper
Katherine Guerry
Hess Corporation
One Hess Plaza
Woodbridge, NJ 07095
jkooper@hess.com
kguerry@hess.com

Allen Freifeld
Samuel A. Wolfe
Viridity Energy, Inc.
100 West Elm Street, Suite 410
Conshohocken, PA 19428
afreifeld@viridityenergy.com
swolfe@viridityenergy.com

Robert Korandovich
KOREnergy
P. O. Box 148
Sunbury, OH 43074
korenergy@insight.rr.com

Chad A. Endsley
Ohio Farm Bureau Federation
280 North High Street
P.O. Box 182383
Columbus, OH 43218
cendsley@ofbf.org

Roger P. Sugarman
Kegler, Brown, Hill & Ritter
65 East State St., Suite 1800
Columbus, OH 43215
rsugarman@keglerbrown.com

Brian P. Barger
4052 Holland-Sylvania Road
Toledo, OH 43623
bpbarger@bcslawyers.com

Summary: Application for Rehearing electronically filed by Ms. Laura C. McBride on behalf of FirstEnergy Solutions Corp.