BEFORE

THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Review of the Delivery Capital Recovery Rider Contained in the Tariffs of Ohio Edison Company, The Cleveland Electric Illuminating Company, and The Toledo Edison Company.	)))))	Case No. 11-5428-EL-RDR

FINDING AND ORDER

The Commission finds:

(1) On August 25, 2010, the Commission issued an opinion and order in *In the Matter of the Application of Ohio Edison Company, The Cleveland Electric Illuminating Company, and the Toledo Edison Company for Authority to Establish a Standard Service Offer Pursuant to Section 4928.143, Revised Code, in the Form of an Electric Security Plan*, Case No. 10-388-EL-SSO (*ESP 2 Case*). In the *ESP 2 Case*, the Commission approved a combined stipulation, as modified, authorizing Ohio Edison Company (OE), The Cleveland Electric Illuminating Company (CEI), and The Toledo Edison Company (TE) (collectively, FirstEnergy or Companies) to establish a delivery capital recovery rider (Rider DCR) effective January 1, 2012. Under the terms of the modified stipulation, FirstEnergy agreed to file quarterly applications to update its Rider DCR. Additionally, under the terms of the modified stipulation, FirstEnergy agreed to submit to an annual audit review process of its Rider DCR applications filed on or about January 31, 2012, January 31, 2013, January 31, 2014, and July 30, 2014. The modified stipulation also provided that Staff and signatory parties to the stipulation would be permitted to file recommendations or objections within 120 days following the filing of the Rider DCR applications.

(2) Thereafter, on February 2, 2012, FirstEnergy filed its Rider DCR applications for OE, CEI, and TE in Case Nos. 12-522-EL-RDR, 12-493-EL-RDR, and 12-523-EL-RDR, respectively.

(3) In the above-captioned case, by entry issued on November 22, 2011, the Commission chose Blue Ridge Consulting Services, Inc. (Blue Ridge), to conduct the audit review of Rider DCR

pursuant to a request for proposal (RFP). On April 13, 2012, Blue Ridge filed a report on its audit review of Rider DCR.

(4) Thereafter, by entry issued on April 20, 2012, the attorney examiner found that interested persons should file comments and reply comments on the audit report by June 1, 2012, and July 2, 2012, respectively.

(5) Initial comments on the audit report were timely filed by FirstEnergy and Staff, jointly, and the Ohio Consumers' Counsel (OCC). Reply comments were timely filed by FirstEnergy and OCC.

(6) The following section contains a general summary of Blue Ridge's audit report, followed by summaries of the comments and suggestions submitted in response to Blue Ridge's audit report, as well as the Commission's responses to those comments.

GENERAL SUMMARY OF AUDIT REPORT

(7) Blue Ridge's report audits the accuracy and reasonableness of FirstEnergy's compliance with its Commission-approved Rider DCR with regard to the return earned on plant-in-service since FirstEnergy's last distribution rate case. Further, the audit identifies capital additions recovered through Riders LEX, EDR, and AMI, or any other subsequent rider authorized by the Commission to recover delivery-related capital additions to ensure they are excluded from Rider DCR. The purpose of the audit was also to identify, quantify, and explain any significant net plant increase within individual accounts. (Audit at 9-10.)

The scope of the project as defined in the RFP was organized into two main areas. Scope Area 1 determines if FirstEnergy has implemented its Commission-approved Rider DCR and is in compliance with the Combined Stipulation set forth in the *ESP 2 Case*. Scope Area 2 examines the effects of the merger between FirstEnergy and Alleghany Energy to determine whether there are net job losses at FirstEnergy as a result of involuntary attrition from the merger. (*Id.* at 10.)

(8) Initially, Blue Ridge's audit report addresses Scope Area 1, which encompasses processes and controls, variance analysis, Riders LEX, EDR, AMI, and general exclusions, gross plant-in-service, accumulated reserve for depreciation, accumulated deferred income taxes, depreciation expense, property tax expense, service company, commercial activity tax and income taxes, return, Rider DCR calculation, projections, and the overall impact of the findings on Rider DCR revenue requirements (*Id.* at 3).

(9) Blue Ridge states that it reviewed FirstEnergy's processes and controls to ensure that they were sufficient so as to not adversely affect the costs in Rider DCR, and concluded that FirstEnergy's cost controls were adequate and not unreasonable. Blue Ridge states that it reviewed FirstEnergy's capital budget process and found that the budgeting process was sound and results in reasonable projections. However, Blue Ridge noted concern with information technology (IT) projects and the level of variability when those types of projects exceeded budgeted costs. (*Id.* at 11.)

(10) Next, Blue Ridge states that it conducted variance analysis of plant-in-service balances including additions, retirements, transfers, and adjustments for FirstEnergy for the years 2007 through 2011. Blue Ridge states that it finds the justification and approval processes for additions to be consistent with industry practices and finds the amount of net plant increase of the period not unreasonable. Further, Blue Ridge finds that the majority of the variances from year-to-year were intercompany transfers, which are not uncommon among utilities with multiple operating companies. (*Id.* at 11-12.)

(11) Blue Ridge next reviewed Riders LEX, EDR, and AMI, as well as general exclusions, and concluded that capital additions associated with Riders LEX, EDR, or AMI had either been appropriately excluded or had never been included within Rider DCR (*Id.* at 12).

(12) Next, Blue Ridge reviewed gross plant-in-service and found that these incremental increases were not unreasonable, with the exception of several minor areas of concern. A minor area

of concern was that a significant portion of IT project costs may lack project controls on spending or may not be thoroughly planned and/or include an appropriate level of budget costs. Consequently, Blue Ridge recommends that the Commission consider a review of FirstEnergy's IT project planning and implementation. (*Id.* at 13-14.)

Additionally, in its consideration of justification and approval of capital projects, Blue Ridge found that segregation of information concerning the planning, approval, and management of capital projects among three processes was a significant deficiency in conducting the audit of Rider DCR. However, after reviewing the three processes, Blue Ridge concluded that the capital budget approval process was sound. Nevertheless, Blue Ridge recommends that, for future audits, FirstEnergy develop information processes that will facilitate the determination that projects in Rider DCR are properly justified, approved, and managed. Blue Ridge also recommends that the Companies reduce the utilization work order backlog before the next audit to reduce the potential for over- or under-accrual of depreciation. Finally, Blue Ridge found that, while there is no evidence to suggest that overhead costs applied were unreasonable, as part of the next audit, FirstEnergy should provide justification and support for the level of overheads that are added to the project and work order costs, providing justification and back-up documentation. (*Id.* at 14-15.)

(13) Next, Blue Ridge reviewed accumulated reserve for depreciation, finding that nothing indicates that accumulated reserve for depreciation is not reasonable (*Id.* at 15).

(14) Blue Ridge reviewed accumulated deferred income taxes (ADIT), identifying a potential concern regarding the ADIT components that are not related to plant-in-service that have been included within Rider DCR. However, Blue Ridge notes that FirstEnergy has presented a compelling argument that non plant-in-service ADIT should be included in Rider DCR, since the non plant-in-service ADIT is included in the May 31, 2007, balances from the last rate case. Consequently, Blue Ridge recommends that the Commission clarify whether the inclusion

of non plant-in-service ADIT meets the criteria for inclusion within Rider DCR. As an endnote, Blue Ridge reports that Staff reviewed this issue as the report was going to print, and that Staff concurs with FirstEnergy's assertion that the treatment of ADIT in the Rider DCR case was intended to be the same methodology approved in the last distribution rate case. Therefore, Blue Ridge states that it removes its recommendation for an adjustment to Rider DCR for ADIT. (*Id.* at 16.)

(15) As to depreciation expense, Blue Ridge reports that it found nothing indicating that depreciation expense is unreasonable (*Id.* at 17).

(16) Next, Blue Ridge reviewed property tax expense, and found several items relating to property tax expense that impact Rider DCR revenue requirements. Blue Ridge reports that OE values from supporting documents had not been carried forward correctly, and that the multiple decimal places used in ratios for all three operating companies creates an illusion of precision, which is misleading in an estimate. Further, Blue Ridge found that the calculations were difficult to update and calculate because they were not integrated within the Rider DCR property tax calculation. Blue Ridge states that OE provided corrected workpapers and the impact that correction would have on Rider DCR. Blue Ridge concluded that the Rider DCR calculated property tax expense was not unreasonable and recommends only that the workpapers surrounding the Rider DCR property tax be cleaned up and fully referenced to minimize future opportunity for error. (*Id.* at 17-18.)

(17) Regarding service company costs, Blue Ridge reports that it found nothing indicating that these costs included in Rider DCR are unreasonable. Further, Blue Ridge found that commercial activity tax and income taxes, return, and Rider DCR calculation were all not unreasonable. However, as to Rider DCR calculation, Blue Ridge recommends that the actual amount collected under Rider DCR be included as part of the quarterly compliance filing to ensure that the $150 million annual cap of collected revenue is not excluded. (*Id.* at 18.)

(18) Blue Ridge next states that it examined FirstEnergy's compliance filing projections for the first quarter of 2012 and found nothing indicating that the projected amounts are unreasonable (*Id.* at 19).

(19) Next, Blue Ridge examined the overall impact of its findings on Rider DCR revenue requirements and notes the cumulative impact to Rider DCR revenue requirements in a table (*Id.*).

(20) Next, Blue Ridge's audit report addresses Scope Area 2: the effects of the merger between FirstEnergy and Allegheny Energy. Blue Ridge states that the Commission agreed not to review the merger because it was an all-stock transition and no change would result in control of the companies; however, the Commission order was very specific in finding that net capital additions for plant-in-service for general plant shall be included in the Rider DCR so long as there are no net job losses at the Companies resulting from involuntary attrition as a result of the merger. Blue Ridge reports that it used two different sources to confirm that the Companies' Ohio employee head count was 4,090 as of February 1, 2011, prior to the merger, and was 4,105 as of November 1, 2011, post-merger. Consequently, Blue Ridge concludes that no net job losses resulted from the merger. (*Id.* at 20.)

<u>COMMENTS AND RECOMMENDATIONS</u>

(21) On June 1, 2012, OCC filed comments on the audit report. In its comments, OCC argues that the Commission should order FirstEnergy to implement the following recommendations contained in the audit report:

(a) Blue Ridge's recommendations itemized in Appendix D of the audit report, which have no direct impact to Rider DCR.

(b) Blue Ridge's recommendation that the Commission consider a review of FirstEnergy's IT project planning and implementation.

(c) Blue Ridge's recommendation that FirstEnergy evaluate the lessons learned from the current audit and develop processes to better facilitate in future audits the determination of whether the projects in Rider DCR are properly justified, approved, and managed.

(d) Blue Ridge's recommendation that FirstEnergy reduce the utilization backlog before the next audit to reduce the potential for over- or under-accrual of depreciation.

(e) Blue Ridge's recommendation that the Commission clarify whether the inclusion of non plant-in-service ADIT meets the criteria for inclusion within Rider DCR, and that each ADIT account be reviewed to determine whether it is an Ohio jurisdiction item.

(f) Blue Ridge's recommendation that FirstEnergy correct errors in the calculation of property tax expense, clean up and fully reference its workpapers supporting the Rider DCR property tax, and reconcile and adjust each Rider DCR annual filing.

(g) Blue Ridge's recommendation that the actual amount collected under Rider DCR be included as part of the quarterly compliance filing to ensure that the $150 million annual cap of collected revenue is not exceeded.

(22) On June 2, 2012, joint comments on the audit report were filed by FirstEnergy and Staff. FirstEnergy and Staff state that they agree the Commission should adopt the recommendations contained in the audit report as specified below:

(a) Blue Ridge's recommendation for an adjustment to Rider DCR regarding the Companies' property tax expense. FirstEnergy and Staff state that the Companies implemented this recommendation in their third-quarter DCR filing.

(b) Blue Ridge's recommendation that the Companies review and address items that have no direct impact to Rider DCR, but are included in Appendix D to the audit report.

(c) Blue Ridge's recommendation that the Commission consider a review of the Companies' IT project planning and implementation.

(d) Blue Ridge's recommendation that, for future audits, the Companies evaluate the lessons learned from the conduct of this audit and develop information processes that will facilitate the determination that projects in Rider DCR are properly justified, approved, and managed.

(e) Blue Ridge's recommendation that the Companies reduce the utilization backlog before the next audit to reduce the potential for over- or under-accrual of depreciation.

(f) Blue Ridge's recommendation that, as part of the next audit, the Companies provide justification and support for the level of overheads that are added to project and work order costs and provide proper justification and back-up documentation to show overheads are appropriate.

(g) Blue Ridge's recommendation that workpapers supporting Rider DCR's property tax be cleaned up and fully referenced in order to minimize the opportunity for error.

(h) Blue Ridge's recommendation that the actual amount collected under Rider DCR be included as part of the quarterly compliance filing in order to ensure that the $150 million annual cap of collected revenue is not exceeded in 2012. FirstEnergy and Staff note that the Companies implemented this recommendation in their third-quarter DCR filing and will maintain the recommendation to ensure the cap is not exceeded in future years.

(23) Thereafter, on July 2, 2012, OCC filed reply comments regarding the audit report. In its reply comments, OCC contends that the joint comments filed by FirstEnergy and Staff did not include two of the recommendations in the audit report. Specifically, OCC points out that Blue Ridge recommended that the Commission clarify whether the inclusion of non plant-in-service ADIT meets the criteria for inclusion within Rider DCR and that each ADIT account be reviewed to determine whether it is an Ohio jurisdiction item. OCC states that FirstEnergy and Staff did not address this recommendation in their joint comments. Next, OCC argues that Blue Ridge recommended that the Commission require a reconciliation and adjustment to actual be done for each Rider DCR annual filing because property tax is an actual expense that can be validated against third-party filings. OCC argues that this recommendation was not addressed by FirstEnergy and Staff, but states that this recommendation is a reasonable audit step to ensure that customers are not being overcharged for property taxes associated with distribution-related plant investments.

(24) Also on July 2, 2012, FirstEnergy filed its reply comments regarding the audit report. In its reply comments, FirstEnergy first responds to OCC's argument regarding Blue Ridge's recommendation that the Commission clarify whether the inclusion of non plant-in-service ADIT meets the criteria for inclusion within Rider DCR and the recommendation that each ADIT account be reviewed. FirstEnergy points out that OCC's comment does not acknowledge the next paragraph of the auditor's report, which noted that "Staff concurs with FirstEnergy's assertion that treatment of ADIT in the Rider DCR was intended to be the same as the methodology approved in the last distribution rate case. Therefore, Blue Ridge has removed its recommendation for an adjustment to Rider DCR for ADIT." (Audit at 16). Consequently, FirstEnergy argues that, because Staff concurred with the Companies and Blue Ridge removed this recommendation, the

Commission should disregard OCC's comment related to ADIT.

Next, FirstEnergy responds to OCC's comment referring to Blue Ridge's recommendation that a reconciliation and adjustment to actual expense of property tax be done for each Rider DCR annual filing. FirstEnergy argues that, currently, all of the rates and ratios used in the Rider DCR calculation of property tax already reflect the most recently filed actual tax return of the Companies. Therefore, FirstEnergy contends, property tax in the Rider DCR filing already reflects actual expenses.

CONCLUSION

(25) The Commission finds that the recommendations by Blue Ridge agreed to by Staff and FirstEnergy and enumerated in Finding (22) are reasonable and appropriate and should be adopted. Additionally, the Commission acknowledges the two areas discussed by OCC in its reply comments regarding adjustment to Rider DCR for ADIT and reconciliation and adjustment to actual expense of property tax for each Rider DCR annual filing. However, the Commission notes that Staff concurred with the Companies that the treatment of ADIT in Rider DCR was intended to be the same methodology approved in the last distribution rate case and that Blue Ridge removed its recommendation. Additionally, the Commission notes that, as to Blue Ridge's recommendation that a reconciliation and adjustment to actual expense of property tax be conducted for each Rider DCR annual filing, FirstEnergy has pointed out that it currently uses rates and ratios in its Rider DCR calculation of property tax that already reflect the most recently filed tax return. Consequently, the Commission finds that the issues discussed by OCC in its reply comments have been adequately addressed and finds that these recommendations need not be adopted. Finally, the Commission finds that, as all issues have been adequately addressed, a hearing process is unnecessary at this time.

It is, therefore,

ORDERED, That the recommendations of Blue Ridge enumerated by FirstEnergy and Staff and summarized in Finding (22) are adopted. It is, further,

ORDERED, That FirstEnergy comply with the recommendations set forth in Finding (22). It is, further,

ORDERED, That a copy of this Finding and Order be served upon all parties of record.

THE PUBLIC UTILITIES COMMISSION OF OHIO

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