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BEFORE

THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of Aligning Electric)
Distribution Utility Rate Structure With)
Ohio's Public Policies to Promote)
Competition, Energy Efficiency, and)
Distributed Generation)

Case No. 10-3126-EL-UNC

PUCO

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COMMENTS OF OHIO EDISON COMPANY, THE CLEVELAND ELECTRIC
ILLUMINATING COMPANY AND THE TOLEDO EDISON COMPANY

Come now Ohio Edison Company, The Cleveland Electric Illuminating Company, and The Toledo Edison Company ("Companies"), by counsel, and respectfully submit their comments in response to the Public Utilities Commission of Ohio ("Commission") Entry, dated December 29, 2010, which required that comments be submitted by February 11, 2011.

The Companies appreciate the opportunity to provide comments to the Commission as it begins its consideration of whether modifications to distribution rate structures for regulated electric utilities in Ohio would better align utility performance with Ohio's desired public policy outcomes; and if so, what modifications should be adopted. The Companies understand that this proceeding is just the first step in the process and that further proceedings and opportunities for input will be provided before the PUCO makes any specific decision to move forward with decoupling.¹ The Companies also recommend that any efforts to implement a straight fixed variable approach for electric utilities not move forward until the electric utility's filing of its next base distribution rate case. The Companies believe that the current distribution rate structure in Ohio, which provides for the recovery of lost distribution revenues, is best aligned

¹ Simply because an issue or comment is not specifically raised regarding a particular item does not constitute a waiver of the Companies' ability to raise the issue at a later date. The Companies reserve the right to modify their comments and to address any and all issues raised with regard to the implementation of decoupling.

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with Ohio's public policy desires and customer interests. To adopt any unproven modifications in the hopes of better alignment may result in unintended consequences contrary to sound public policy and may well create an unnecessary administrative burden associated with frequent rate proceedings. Absent a showing that the current distribution rate structure is contrary to Ohio public policy, the Companies believe it is premature to consider modifications. The Companies comments are structured with general comments immediately set forth below and responses to the questions posed in their Entry following the general comments.

I. General Comments

In its Entry, the Commission identified at least three separate forms that it has characterized as potentially falling under the "decoupling" banner, including a straight fixed variable approach, periodic rate modifications, and lost revenue recovery. The Entry then goes to suggest that combinations of these three may also be considered by the Commission. The Companies believe that attempting to recover all fixed distribution costs through a single customer charge applied to all customers, i.e., straight fixed variable ("SFV"), ignores the cost causation principle of ratemaking and may have the effect of shifting cost recovery from higher-usage customers to lower-usage customers. As described in the Entry, both the SFV design and the Decoupling adjustment design would fix distribution revenues while ignoring changing distribution system costs. The Companies believe that the traditional distribution base rate cases together with lost distribution revenue recovery for energy efficiency related reductions in sales is an appropriate middle ground between a SFV/rate modification approach and traditional rate cases with kWh distribution charges, and best supports the public policy desires of Ohio. This approach, coupled with distribution rates designed based on a customer's demand, significantly

reduces the throughput incentive, keeps intact the cost causation principle and simultaneously maintains customer incentives to support energy efficiency efforts.

Recognizing this, during the Companies' last distribution rate case the Companies altered the distribution rate design to incorporate charges based on billing demands and customer charges wherever possible. *See* Case No. 07-551-EL-AIR. The Companies' nonresidential distribution rates, General Service-Secondary (Rate GS), General Service-Primary (Rate GP), General Service Sub-Transmission (Rate GSU) and General Service-Transmission (Rate GT) now contain only demand-related charges and a customer charge.

The only distribution rate that is not structured based upon a demand charge is the residential tariff simply because the installed metering does not capture the billing determinants necessary to charge based on demand. The cost to install the metering necessary to measure demand for the residential rate schedule is prohibitive. Instead of a demand based rate, residential customers' distribution rate consists of a fixed component, or service charge, and a kWh energy charge. For residential customers, this is a reasonable rate design because of the correlation between energy consumption and demand, i.e., the energy charge serves as a reasonable proxy for the residential customers' distribution demand. Based upon the support of most parties to the Companies' distribution case, the Commission approved the rate design in its Order in that case. With those changes in place, the Companies then sought and were granted recovery of lost revenues for energy efficiency and peak demand reduction programs through the Commission's adoption of the Stipulation in the Companies' first and second ESP proceedings, Case Nos. 08-935-EL-SSO and 10-388-EL-SSO respectively. The Companies believe this structure addresses the concerns expressed in the Entry regarding the "throughput incentive",

fundamentally preserves the existing distribution rate design and supports energy efficiency and peak demand reduction efforts.

A. Distribution Tariff Design and Changing Cost to Serve

Distribution rates resulting from a distribution base rate case represent a snap shot in time of what customers should be charged for distribution service based upon the evidence that was presented during the proceeding. The many variables that make up the cost of providing distribution service begin to change even before an order is issued in a case. For example, rate base changes, operation and maintenance costs change, sales volumes change, customer counts change, weather changes, the economy changes and end-use saturation rates change. Given those changes, while rates may remain reasonable, they will never universally reflect precise cost recovery over the period the rates are in effect. The historic balance that has been struck, and remains in place today, is that if the rates do not provide sufficient revenues to provide adequate service and a reasonable return, then an electric utility may file a request with the Commission to increase rates. Conversely, the Commission tests utility earnings on an annual basis to determine if the current rates are providing a significantly excessive return, and if so, has mechanisms at its disposal to address the situation.

Both the SFV and the Decoupling Adjustment approaches discussed in the Entry address only one of the components that make up the rates of an electric utility, i.e., revenue. The premise appears to be that an electric utility should not be permitted to collect more than its authorized revenue and that these approaches would be applied to ensure that they did not. But authorized revenue is not the determinant or driving force behind setting rates. As recognized in the Entry, the definition of decoupling for gas companies is a mechanism “that provides recovery of fixed costs of service and a fair and reasonable rate of return, irrespective of system

throughput or volumetric sales.” Entry at 3. Consistent with this definition, an electric utility is permitted to recover its prudently incurred costs together with an opportunity to earn a fair and reasonable return on its investment. Thus, it is the combination of costs plus a return that are the critical components of utility rate setting. The authorized revenue is simply the end result of a mathematical formula, and forms the basis for the development of the rates to be charged to customers.

By providing an adjustment mechanism to ensure that only the “authorized” revenue amount from a previous rate case is permitted to be collected, changes in costs necessary to provide safe reliable service to customers are ignored. If either SFV or the Decoupling Adjustment were implemented in an increasing cost environment, then the logical outcome of resetting revenue collected to the amount needed to recover an historic and no longer accurate level of costs would be almost continuous base distribution rate cases being filed. This sort of regulatory churn is costly both in terms of economic and human resources, and is unnecessary. Rate cases should only be filed when the electric utility’s rates do not permit it to earn a reasonable return. SFV or a Decoupling Adjustment should not be used to carve out one element of the ratemaking formula to the detriment of customers, the Commission, the Companies, and other interested stakeholders.

The Companies, and presumably the other electric utilities in the state, are in a rising cost environment - the cost of constructing and maintaining the distribution system continues to rise. For instance, in the past seven years the Companies have witnessed the following cost increases in the basic material it uses:

- Line Transformers 177%
- Underground cable 82%
- Overhead wire 129%
- Power transformers 109%

- Conduit 41%
- Line Trucks 51%
- Treated wood poles 35%

The risk faced by the Companies would also increase as the result of the implementation of either the SFV or Decoupling Adjustment approach to decoupling. Effectively having a rate case every year, or possibly even more often, could increase the regulatory risk and uncertainty for investors and will also substantially increase rate case expense, the cost of prosecuting rate cases, on the part of the Companies, interested stakeholders, and the Commission itself. And it is not needed. Under the current structure, Companies file rate cases only when needed to adjust rates to permit them the opportunity to earn a reasonable return – which provides a level of stability to the rates and an amount of certainty for customers and the Companies.

B. Other Expected Impacts of SFV

One impact on customers of a decoupling mechanism would be price signals that undermine that value of conservation and peak demand reduction for customers, which may cause customer confusion and conflict with the state policy initiative of increasing energy efficiency and reducing peak demands. Further, the Rider USF charge, which is the Rider that recovers PIPP program arrearages, may well increase as the shift to SFV causes both the level of arrearages from current PIPP customers to rise as well as the number of PIPP customers to rise.

First, with a shift to SFV, the kWh or kW charge for distribution service will be reduced or eliminated. A byproduct of this change in distribution system rate design will be to reduce the savings that customers experience either through energy efficiency and/or peak demand reduction efforts. Customers will have less of an economic incentive to participate in

energy efficiency or peak demand reduction programs resulting in an increase in the cost of the programs in order to achieve the statutorily required savings and reductions. This comes about because the customer is expecting that as they conserve energy or reduce their peak demand there will be a reduction in their distribution bill. If this doesn't happen, the economic incentive to reduce usage is reduced. By changing the price signals, the SFV rate design promotes the opposite outcome of the policy intent set forth in SB221 by reducing the benefit to customers who take the necessary steps to conserve energy. Such an approach seems antithetical to the requirements of R.C. 4928.64 and R.C. 4928.66. If the SFV approach with a revenue adjustment were implemented, customers will have to be given greater incentives to participate in order to achieve the Energy Efficiency and Peak Demand Reductions required by statute. This will cause higher amounts to be recovered through Rider DSE, which are paid for by all customers. Diminishing the value of energy efficiency and peak demand reduction for customers may also be seen as inconsistent with R.C. 4928.02, particularly divisions (D) and (M) that encourage the use of demand side management and energy efficiency programs.

A second consequence of a SFV decoupling mechanism is the unanticipated harm that could arise from going to a design that includes a much higher customer charge. This will negatively impact low use customers the most. The shifting of cost recovery may also be seen as inconsistent with R.C. 4928.02(L), which is the policy statement to protect at-risk populations. To the extent these low use customers are also low income customers and these low use customers are already participants in the PIPP program, shifting revenue responsibility will not increase their obligation to pay, but will simply shift more dollars into the USF rider that all customers pay. Further, substantially increasing the cost for low income customers that qualify for PIPP, but that do not currently participate in the PIPP program may well drive substantially

more customers to join the PIPP program, thereby increasing the USF Rider even more and further shifting the burden to other customers.

C. Companies' Approach

As noted above, the Companies acknowledge the Commission's concern with the recovery distribution system costs through purely kWh charges. The Companies in their last distribution rate case, in large part, converted kWh or usage based charges into kW or demand based charges for the non-residential schedules. This approach addresses the basic "throughput incentive" concern expressed by the Commission in the Entry.

The Companies have also recognized the special circumstance arising from the requirement to achieve energy efficiency and peak demand reduction benchmarks set out in SB221. The Companies view this as an isolated circumstance that should be addressed through the recovery of lost revenues without specifically impacting overall distribution rate design. The Companies believe the Commission should provide a mechanism where the recovery of costs associated with energy efficiency and conservation programs, including lost distribution revenues, can be approved in a timely manner so that customers may take advantage of new opportunities to conserve energy.

The existing distribution rate design is based on decades of cost of service studies and related distribution rate design both of which are based on well-established rate making principles that have been tested in countless proceedings. Nothing has changed to alter the underlying basis for that body of work or the resultant rate design. To toss out what we have without any showing that it is improper or counter to public policy is inappropriate. For example, with regard to cost causation and recovery of distribution system costs from those

customers causing the cost, the SFV approach suffers from many limitations. Principally, the costs are not being recovered from the cost causers. Without metering to measure the demand of residential customers, the precise cost of the distribution system cannot be allocated on a pure cost basis. Simply dividing total fixed costs by the number of customers to result in a fixed monthly charge does not recognize that higher level users are causing higher than average costs on the distribution system. Adopting the SFV approach may simply flip the presumed existing higher-use customer subsidy of lower-use customers to just the opposite, i.e., lower-use customers subsidizing higher-use customers. With the Companies' current structure, as a customer's demand increases (or usage in the case of a residential customer) the more distribution costs are recovered from that customer. This is appropriate since they are causing the higher costs to be incurred on the system.

The Companies further believe before any modification to the existing rate design is considered, much less implemented by the Commission, customer attitudes must be tested to determine the receptivity to modifications to rate design. Experience demonstrates that customers are sensitive to changes in the billing for their electricity consumption. Even rate design changes that are revenue neutral within a class can create a customer reaction that overwhelms any positive intent of the change.

In conclusion, if current distribution rate design is changed such that reducing consumption or demand no longer provides any savings to customers, then the simple message to customers of: "If you use less, you can save money on your bill" will be lost for distribution related charges.

II. Responses to Questions Posed in the Entry

1. *Are there fundamental operational distinctions between natural gas & electric utilities that must be considered in determining whether and how to eliminate or mitigate the throughput incentive in electric distribution rates?*

There are attributes unique to the electric distribution businesses that influence distribution rate design that should be considered when considering modifications to the distribution rate design.

a. The electric distribution system is designed to accommodate individual customer and class peak demands that are driven by instantaneous loads. The utility has to install and maintain sufficient distribution capacity to meet customers' peak demands even as these load centers shift and migrate with customers.

b. To the extent that customers' individual demands continue to grow, additional plant capacity is needed regardless of the changes, if any, in the number of customers on the system

c. Unlike natural gas, consumption of electricity and the number of electric utility customers continue to grow driving the need for investment in the distribution system. For the period 2002 – 2009 average residential electric consumption grew 1%. This growth has occurred even during a period of recession. During this same time period, average residential natural gas consumption fell by 12%. Decoupling may make sense in a declining sales industry, like natural gas, but it is wholly inappropriate in the electric industry where sales and costs are increasing.

d. Although kWh usage or throughput may not directly cause the costs that drive capital investment in the distribution system for the residential class, a correlation between kW demand and kWh usage has been exhibited. Simply put, customers who use more electricity have higher demand for electricity and require more distribution infrastructure to serve.

e. Increasing mandates and policy support for distributed generation, net metering, new reliability standards, smart grid, and renewable resources create new operational challenges on the distribution system that must be addressed and will likely give rise to the need for additional distribution investment. These requirements are unrelated to the costs of the existing distribution system, the volume of kWh sales or the number of customers on the system. But these new requirements must be recognized in any distribution rate design going forward.

2. *Are there factual or policy considerations that suggest electric distribution rate design should be constructed differently from natural gas?*

Yes. First, electricity usage on average for residential customers is trending upward whereas residential natural gas usage is trending downward. Second, electric utilities have statutorily mandated energy efficiency and peak demand reduction benchmarks. Third, gas companies do not have a state policy consideration to protect at risk populations. Fourth, the electric utilities are required to meet Commission mandated minimum reliability standards. Fifth, annual gas usage patterns vary significantly from that of electricity usage. As a result of the foregoing, the Companies favor a distribution rate design that:

- a. Recognizes electric distribution rate design should be based on its unique operational attributes. Costs are caused by building the system to meet individual customers' and class peak demand
- b. Includes tariffs designed to spur efficiency from a utility and customer perspective.
- c. Fully compensates utility participation in approved energy efficiency and peak demand reduction programs through timely recovery of ongoing costs on a standalone basis, including fair return on invested capital, and recovery of lost revenues.
- d. Enables utility customers to effectively use the utility service while understanding the drivers of their costs to use the service

3. *If the Commission adopts a decoupling rate design, which design should it use: SFV, decoupling adjustment, lost revenue recovery adjustment, or a combination?*

The Commission should continue with distribution rate design that is based on a customer's peak demand where practicable and based on kWh usage otherwise, coupled with a lost distribution revenue recovery mechanism. The lost revenue recovery adjustment meets the goals of SB221 by encouraging the utility to support energy efficiency and peak demand reduction while allowing for investment where necessary to continue providing adequate service in an environment of usage, demand, and customer growth.

Moving to a SFV design where customers are charged a fixed charge for distribution and a variable charge for generation diminishes the customer incentive needed to spur distribution efficiency and demand reductions from a customer perspective. It will result in a shifting of costs from higher-usage customers to lower-usage customers, without assurance that the new distribution rate design more properly assigns costs to cost causers. Again, this quick fix to a problem that no one has demonstrated exists throws out decades worth of studies designed to identify the distribution cost causers. Additionally, the SFV rate design makes adjustments only to revenue levels while ignoring an electric utility's ability to recover its prudently incurred costs, particularly increasing costs associated with materials cost increases and an opportunity to earn a reasonable return on investment.

4. *If the Commission adopts a decoupling rate design in electric distribution rates:*
- a. *Should it only be applied to residential classes? What other classes?*

As one element of an overall rate design, lost distribution revenue should be recovered from all customer classes other than GT.

- b. *How often should the Commission require a utility to update?*

The current framework, which allows utilities to determine when they need to seek a change to distribution rates, is appropriate and provides balance and stability to customers and the electric utility while also providing appropriate flexibility. In addition, the Companies believe that the current method of collecting lost distribution revenues through the Company's Rider DSE, Demand Side Management and Energy Efficiency Rider, is the most appropriate.

The Commission has the opportunity to review the lost revenue recovery at least semi-annually when the rider updates are submitted for review and approval.

c. Should rate of return be adjusted to reflect reduced risk?

No, a utility's rate of return is a function of a myriad of issues and adjusting the rate of return because a lost revenue recovery mechanism exists smacks of single issue rate making and overlooks the fact that investing in energy efficiency and peak demand reduction measures along with distributed generation and renewable resources actually increases the risks associated with operating a distribution utility. Further, if the SFV design is implemented as described in the Entry, then the risk of the electric utility would actually increase. Fixing revenues does not equate to fixing earnings. As previously stated distribution expenses rise between rate cases so fixing revenue may actually increase the variability of earnings. This business risk is what drives a company's cost of capital because investors must bear it. Fixing revenues may actually increase the business risk for the utility and therefore investors' required return. In many cases where rate of returns have been modified in other states, they have been adjusted on an arbitrary basis based on the perception of lower risk rather than an actual study of the business risk.

5. If the Commission adopts some element of a decoupling rate design:

a. Should adjustments be made on total revenue, per customer revenue or some other basis?

A lost revenue recovery approach would not require separate adjustments to total revenue or per customer revenue. Other decoupling rate designs would need to be adjusted for inflation, weather, economic growth, growth in numbers of customers and growth in peak demand because many of these actually increase distribution costs for the company.

b. Should adjustments be normalized for weather?

See the response to (a).

c. Should the Commission adopt any special features to shield consumers from volatile adjustments (e.g. caps, collars, bands?)

No, such special features should not be needed if the Commission implements a rate structure that avoids the occurrence of the necessity for "volatile adjustments." If the Commission fails to do so, then it should adopt mitigation features and the Company should be allowed to defer adjustments with full carrying charges including cost of equity.

6. If the Commission determines that a decoupling rate design should be implemented to eliminate or mitigate the throughput incentive in electric distribution rates:

a. When should this change occur (i.e. in what types of actions before the Commission should this change be implemented?)

The Commission should strive to support rate design that is based on cost causation. As stated above, the Commission should not consider a SFV rate design for residential customers until costs can be properly assigned. When the information is available to support an allocation of fixed costs to customers is when the Commission should consider such action. Also, the timing of any efforts to change rate design needs to respect the many important aspects of current ESPs approved by the Commission and to not disturb the careful balance struck in those plans by changing distribution rate design prior to their expiration. The Companies recommend that any efforts to implement a straight fixed variable approach for electric utilities not move forward until the electric utility's filing of its next base distribution rate case.

b. Should it be phased in?

To the extent that any rate design causes shifts the allocation of costs from one set of customers to another, particularly when the rates are designed without regard to cost causation and result in significant increases in costs to certain customers and significant decreases in costs to other customers, the rates should be phased in.

c. Over what period of time?

It would depend how much customers are harmed and this would vary by operating company and the rate design chosen. For example on average across the Companies' service territories, under a fixed charge scenario a customer who uses an average of 400 kWh per month would see their bills for distribution go from \$21/month to roughly \$27/month or \$252/year to \$325/year. Smaller customers such as these would experience large percentage increases if rates were not phased in.

7. In order to review the various decoupling rate designs, the Commission will need necessary data such as that included in Appendix B. Is the data contained in Appendix B:

- a. Burdensome*
- b. Appropriate*
- c. Comprehensive*
- d. Proprietary*

In order to provide the types of information described in Appendix B, the Companies would need to conduct special studies which would be time-consuming and burdensome. The information described on Appendix B is not comprehensive however. The appendix is looking at one year's worth of information – the Companies believe that there should be the option to look at more than one year. The year 2010, for example, was impacted by both the economy and the extreme summer weather, which if viewed in isolation could lead to inaccurate conclusions.

In addition, using average bills and figuring out how many bills are above and below those levels ignores the types of customers being impacted. In making any decision on a rate design methodology that would re-allocate recovery of costs among types of residential customers, more information needs to be considered than is being requested in Appendix B. In addition, the consideration of what customers or customer groups are causing the distribution costs needs to be part of any discussion of changing rate designs. The Commission should put

off discussions about changing rate design until more information is available regarding individual contributions toward peak demand by different types of residential customers.

While the nature of the information described below, to a large degree, would not necessarily be considered proprietary at the preliminary juncture, the Companies reserve all of their rights to protect the confidentiality of any information that may be subsequently required to be produced.

III. Conclusion

The Companies appreciate the opportunity to provide comments related to the Commission's consideration of the issue of decoupling, and urge the Commission to move with great caution when considering modifications to the existing distribution rate design. We look forward to providing additional input should the occasion present itself in the future.

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Respectfully submitted,

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