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

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| **In the Matter of the Application of Ohio Edison Company, The Cleveland Electric Illuminating Company, and The Toledo Edison Company For Approval of a Competitive Bidding Process For Standard Service Offer Electric Generation Supply, Accounting Modifications Associated With Reconciliation Mechanism and Phase In, And Tariffs for Generation Service** | ) ) ) ) ) ) ) ) | **Case No. 07-796-EL-ATA** **Case No. 07-797-EL-AAM** |

**Reply Comments of**
**Columbus Southern Power Company**
**and Ohio Power Company**

On July 10, 2007, Ohio Edison Company, The Cleveland Electric Illuminating Company, and The Toledo Edison Company (collectively, FirstEnergy), in accordance with §4928.14, Ohio Rev. Code, and the Commission's regulations for Market-Based Standard Service Offer (SSO) and Competitive Bidding Process for electric distribution utilities (Chapter 4901:1-35, Ohio Admin. Code), filed for approval of a competitive bidding process (CBP) designed to procure supply for the provision of Standard Service Offer electric generation service to retail electric customers who do not purchase electric generation service from a competitive retail electric service provider beginning January 1, 2009. Columbus Southern Power Company and Ohio Power Company (collectively, AEP Ohio) sought intervention regarding the general CBP issues and proposed that the Commission adopt a CBP design in this proceeding for use by Ohio's electric distribution utilities (EDUs) which, based on current law, will implement market-based rates at the conclusion of their current rate stabilization plans – including AEP Ohio.

AEP Ohio submitted initial comments on September 5, 2007, as did several other stakeholders. AEP Ohio expressed its view that there are numerous potential benefits associated

with expanding the proposed CBP. AEP Ohio generally endorsed FirstEnergy's proposed CBP design as being well-developed and proven as an auction method to be transparent and fair. AEP Ohio addressed various other aspects of the proposed CBP. As previously indicated, AEP Ohio plans to soon file its own application to formally propose that this common CBP process also be used for AEP Ohio. While AEP Ohio rests on its initial comments endorsing the CBP proposal and will leave it to FirstEnergy to defend its proposal in greater detail through reply comments, AEP Ohio would like to use this opportunity to reply to the comments submitted by the Staff concerning the wholesale electricity market.

Prior to addressing Staff's assertions, AEP Ohio notes that no other party besides Staff broadly attempts to support the position that the wholesale market has failed. Of particular significance is the fact that the Ohio Consumer Counselor (OCC) does not claim that the market has failed or otherwise broadly oppose adoption of the CBP; instead, OCC makes proposals to modify it for use in determining rates for customers beginning in 2009. Likewise, Industrial Energy Users-Ohio (IEU-OH) does not launch an attack on the underlying competitive market. Rather, those parties seem to recognize that a competitive bidding process is consistent with existing law. By the same token, it is also noteworthy that the would-be suppliers and competitors (*i.e.*, CRES providers and marketers) support the competitive market and generally support the CBP proposal.

## ARGUMENT

### I. Ohio is Part of a Robust Regional Energy Market and the Commission should reject Staff's position that the CBP should not be used due to a lack of development in the wholesale and retail electricity markets.

Staff concludes (at page 1) that restructuring of Ohio's electric generation business has thus far failed to produce an efficient, competitive retail market. As a result of its assertion, Staff

recommends that the Commission reject the CBP as a means of establishing the price of a standard service offer. Contrary to Staff's comments, AEP Ohio submits that Ohio is part of a robust regional wholesale power market that, if permitted by regulatory policies, will drive an efficient and competitive retail market.

As provided for in S.B. 3, Ohio Electric Distribution Utilities (EDUs) have transferred functional control over their transmission facilities to independent regional transmission organizations (RTOs). Specifically, AEP Ohio and Dayton Power and Light Company have integrated into PJM Interconnection (PJM) and FirstEnergy and Duke have integrated into the Midwest ISO (MISO). The RTOs were initially created to ensure independence from owners of generation assets, promote non-discriminatory access to the transmission grid and avoid "pancaking" rates among transmission areas. The purpose of RTOs has evolved and been significantly enhanced beyond the original design.

Today RTOs are not only responsible for ensuring non-discriminatory access and reliability of the electric power supply system in parts of 19 states, the District of Columbia, and part of Canada, but also for operating efficient and effective wholesale regional electricity markets. The administration of the markets includes dispatching utility generating units in the most economic manner for the region and functionally controlling the utility's transmission facilities on a regional basis to enhance reliability and provide transmission access to third parties, thereby further supporting a competitive market for electricity. Because these markets were not contemplated when RTOs were initially established, it is necessarily true that the subsequent addition of this important function exceeded expectations for the development of RTOs. Consequently, it is disingenuous to claim that RTO markets have failed the purposes of SB 3 to produce a more competitive wholesale market.

On the contrary, virtually all of the generation produced and delivered today by EDUs in Ohio is cleared through the PJM and MISO markets. For example, last year, the total peak load and generation in PJM was about 145,000 MW and 165,000 MW, respectively, and cleared 729,000 GWh of energy. By comparison, the PJM market clears more than four times the energy that is used by the entire State of Ohio (which utilizes approximately 190,000 GWh of energy annually). Geographically, the PJM market is also much larger than Ohio, stretching east to New Jersey, west to Illinois and south to North Carolina.

These RTOs provide access to economically priced generation within their footprints to retail and wholesale customers. The organized markets operated by RTOs have resulted in greater price and cost transparency and have provided motivation for sound investments where needed. The Federal Energy Regulatory Commission (FERC) has given authority to independent market monitors to provide assessments of the state of the RTO markets, including PJM and MISO in Ohio, and generally examine the efficiency and efficacy of those markets. This oversight of the organized RTO markets, such as the function exercised by the PJM Market Monitoring Unit (MMU), helps ensure transparency, fair competition and an absence of the exercise of market power. The PJM MMU monitors the market on an ongoing basis and periodically issues various analyses, including a comprehensive state-of-the-market report that assesses the state of competition in each market operated by PJM, identifies specific market issues and recommends potential enhancements to improve the competitiveness and efficiency of the markets. On a daily basis, the PJM MMU reviews the day-ahead offers submitted by the generators for energy, regulation and spinning reserves to identify any market power concerns.

The competitive significance of RTOs is well recognized. In *New PURPA Section 210(m) Regulations Applicable to Small Power Production and Cogeneration Facilities*, Docket

No. RM06-10-000, FERC Statutes and Regulations ¶31,233 (October 20, 2006) ("*Order 688*"), the FERC found that both MISO and PJM are independently administered, auction-based day-ahead and real-time wholesale markets for the sale of electric energy. The FERC also found that the existence of wholesale markets for long-term sales of capacity and electric energy is satisfied by the existence of long-term bilateral contracts for sales of capacity and energy and is a sufficient indication of a market. *Order 688* ¶117.

The PJM energy market provides substantial benefits to the region based on its ability for utilities and customers to access a larger number of generation resources to fulfill load requirements while utilizing a robust transmission system. PJM's methodology results in the least cost generating units serving the load requirements, subject to any transmission constraints. This method is similar to the one performed by AEP for its system prior to joining PJM. PJM, however, provides access to additional generating units and the capability of importing generation from MISO without paying additional transmission rates. The resulting dispatch price provides transparent economic signals that guide short- and long-run decisions by participants and regulators.

**A. Retail switching develops when retail customers are given appropriate price signals reflective of wholesale market prices.**

Staff argues (at page 2) that Ohio's electric restructuring law, which was enacted in 1999, clearly envisioned the development of a fully competitive retail electric market where consumers would be able to choose from among a large number of Competitive Retail Electric Service (CRES) providers to supply their electricity. AEP Ohio disagrees with Staff's comment that the perceived failure of retail markets in Ohio reflects the failure of wholesale markets to discipline prices to reasonable levels. The lack of retail competition does not reflect failed wholesale markets. As a result of retail prices being constrained to below-market levels by regulatory

policies (*i.e.*, rate stabilization plans voluntarily entered into at the request of the Commission), the retail market potential was not permitted to fully develop in Ohio. Initially, during the Market Development Period, retail competition was significant, as evidenced through retail customer switching levels through 2005. This was particularly true for the FirstEnergy operating companies that have retail rates that are closer to wholesale market prices. For example, as of December 2004, 69% of Cleveland Electric Illuminating Company's residential customers had switched to alternative providers, 75% of its commercial customers had switched and 25% of its industrial customers had switched.

That level of switching indicates the strong retail market potential that exists when rates are reflective of wholesale market prices and customers are given appropriate price signals. By contrast, because AEP Ohio's retail rates have been below market, a meaningful amount of switching did not occur. And once the Commission implemented its Rate Stabilization Plan approach to follow the Market Development Period, retail competitors retreated from the retail market because this action signaled that there would be limited movement toward market prices as provided by S.B. 3. In addition, as fuel and emission prices rose, retail aggregators found that they simply could not economically offer a rate underneath that of the price contained in the Rate Stabilization Plan. This is because retail prices have been artificially constrained from tracking the competitive wholesale market.

As mentioned, the other key component to effective retail competition is putting the power of choice in the hands of retail customers by providing them with accurate price signals. FirstEnergy's proposal for time of day and seasonal pricing for retail customers is a step in the right direction. Adding another key component for retail choice, AEP announced on October 4, 2007 that it is working with General Electric to bring "smart meters" to 200,000 customers by

the end of next year and to all of AEP's customers by 2015. Although retail market competition has not evolved as envisioned at this time as a result of rate stabilization plans, with the existing competitive wholesale market, and the appropriate price signals, retail markets can fully develop.

**B. Price increases to consumers in a competitive market cannot automatically be construed as a market failure.**

Staff argues (at page 6) that the alleged failure of retail markets in Ohio reflects the failure of wholesale markets to discipline prices to reasonable levels. Staff does not explain why the prices are not at reasonable levels in any absolute or market-based sense; rather, it seems to simply be driven by the relative position of current RSP rates. Wholesale markets operating in areas covered by RTOs are recognized as competitive by a wide range of market participants and market observers, and have provided substantial benefits. Contrary to conventional wisdom, a Cambridge Energy Research Associates (CERA) study found that U.S. residential electric customers paid about $34 billion less for the electricity they consumed from 1998-2005 than they would have paid if traditional regulation had continued.[1] LECG identified savings of $430 million to $1.3 billion per year in the PJM and New York ISO region, respectively.[2] There have been environmental benefits as well as monetary benefits. At the February 2007 FERC conference on Competition in the Wholesale Markets, the American Wind Energy Association submitted this testimony:

> Well-structured regional wholesale electricity markets operated independently allow for greater amounts of renewable energy and demand response resources to be integrated into the nation's electric grid. In fact, approximately 73 percent of installed wind capacity is now located in regions with such markets, while only 44 percent of wind energy potential is found in these areas.[3]

[1] Beyond the Crossroads: The Future Direction of Power Industry Restructuring, CERA, November 28, 2005
[2] Analysis of the Impact of Coordinated Electricity Markets on Consumer Electricity Charges, LECG, November 20, 2006 (Revised June 18, 2007)
[3] Testimony before the Federal Energy Regulatory Commission – Conference on Competition in Wholesale Power Markets, Robert Gramlich, American Wind Energy Association, February 26, 2007.

Paul Joskow, Director of the MIT Center for Energy and Environmental Policy Research, submitted in testimony before the same FERC conference that "the markets in the Northeast and Midwest organized around an [Locational Marginal Pricing] model and managed by an Independent System Operator now work well in almost all dimensions."[4] (Locational Marginal Pricing (LMP) is discussed further below in Section M.) Ultimately, wholesale competition has resulted in much more efficient use of the transmission grid and the nation's generating fleet. The evidence that competitive electricity markets are providing substantial benefits continues to mount. Also submitted at the FERC conference was the following statement in an open letter by eight well-respected economists, including one Nobel Laureate in Economics stated:

> We are concerned that faulting competitive markets for today's high prices diverts the focus and resolve of policymakers to continue with restructuring and make further improvements in market institutions and design in order to provide consumers with the full benefits of competition. First, competition and markets are not to blame for recent increases in electricity prices. The current high electricity prices are largely a result of dramatically higher fuel costs.[5]

Although price increases in competitive states are frequently mentioned during policy debates concerning the wholesale power market, what is rarely discussed are the price increases that have occurred in regulated states. For example, as reflected in Appendix A, during the period of 2002-2006, Florida saw a 39% increase in the last four years, Mississippi a 29% increase and Wisconsin a 28% increase during the same period. U.S. Department of Energy data from the Energy Information Agency (EIA) from 1999 through July 2006 shows a minor difference in prices paid by residential customers based on the same regulated/deregulated state breakdown

[4] US Federal Energy Regulatory Commission – Conference on Competition in Wholesale Power Markets, February 27, 2007
[5] Ibid

that staff cited from the USA Today article.[6] The data reveals that prices increased in regulated states by 23% and by 25% in deregulated states. The data used in the article reflects prices beginning in 1990, which bias the results as deregulation began to take hold in the late 1990's.

Additionally, Texas has been identified by some as an example of a competitive market in trouble. The average price of electricity has gone from 7.17 cents per kWh in 1995 to 9.14 cents in 2005. However, seventy percent of Texas industrial customers have switched providers and there are dozens of competitive suppliers. Electric rates in Texas are increasing at an average of 23 percent (adjusted for inflation), which is 17 percent higher than the national average. But it should also be noted that Texas generation is 72 percent natural gas, which has seen a 200 percent price increase in the past five years. In summary, price increases to consumers in a competitive market cannot automatically be construed as resulting from a flawed market – especially given that electricity prices have increased substantially under traditional regulation.

**C. The track record of energy auctions conducted in Ohio and other states shows the market's ability to support large scale procurements.**

Staff (at page 8) raises some concerns about the competitive bids in other states (whether wholesale markets can support large scale procurements) and whether or not the MMU is independent. The market supported FirstEnergy's 2004 auction in Ohio by supporting the required load, even though FirstEnergy Solutions was not among the winning suppliers. In addition, the markets in other states clearly demonstrate that they are able to support large scale procurements. In fact, the auctions that took place in New Jersey, Maryland, and Illinois provide evidence that suppliers have confidence in the robust and credible wholesale markets.

In New Jersey, the Basic Generation Service Commercial and Industrial Energy Pricing (BGS-CIEP) Auction demonstrated that a large number of bidders were willing to respond to the

[6] http://www.eia.doe.gov/cneaf/electricity/epa/average_price_state.xls

available tranches offered. The BGS-CIEP Auction began on February 2, 2006 and ended on February 6, 2006 after 29 rounds with all of the Electric Distribution Companies' (EDC)[7] 120 tranches[8] secured.

Additionally, the BGS Fixed Priced (BGS-FP) Auction also demonstrated that a large number of suppliers were willing to respond to the solicitation for bids. The BGS-FP Auction which began on February 5, 2006 and ended on February 7, 2006 after 22 rounds with each of the EDC's 51 tranches[9] secured. The 2006 BGS auction represented the sixth year for which the New Jersey Board of Public Utilities (NJ BPU) certified a similar auction to secure BGS supply.

The state of Maryland also conducted an auction for Standard Offer Service (SOS) Bids for all four major electric distribution companies in Maryland. There were sixteen (16) eligible bidders in the process and ten (10) suppliers that won some portion of the load offered. Starting in June 2006, twelve (12) different suppliers were serving the SOS customers.

The September 2006 Illinois Auction provides another example regarding the ability of wholesale markets to support large scale procurements. The Illinois Auction was designed to procure wholesale commitments from bidders to supply, beginning in January 2007, all the electric energy needs of retail customers served by the Commonwealth Edison Company (ComEd) and the three Ameren utilities doing business in Illinois. There were 21 registered bidders in the Illinois Auction and 16 of them were winning bidders. More specifically, there were 14 winning bidders for the various fixed price products and all 14 entered into wholesale supply contracts with ComEd. There were 9 winning bidders for the various Ameren fixed price products and all 9 entered into wholesale supply contracts with the Ameren utilities.

[7] EDC refers to the collective name of Public Service Electric and Gas Company (PSE&G), Jersey Central Power &Light Company (JCP&L), Conectiv Power Delivery (Conectiv) and Rockland Electric Company.
[8] A tranche in the BGS-CIEP Auction is equivalent to approximately 25 MW.
[9] A tranche in the BGS-FP Auction is approximately 100 MW.

The New Jersey, Maryland, and Illinois auctions demonstrate that the wholesale market is indeed able to satisfy the needs of a large procurement process. In each process, independent consultants, advisors, and/or monitors were employed to ensure the credibility of the auctions. The independent entities ensured the credibility to the solicitation process. This assurance of credibility led bidders to participate in the auctions. Bidders gain peace of mind knowing that a fair and impartial entity is reviewing the details of the solicitation process, which was the case in the New Jersey, Maryland and Illinois auctions.

The PUCO Staff apparently attempts to cast doubt as to the PJM MMU's independence by referring to the reluctance to help New Jersey and Maryland investigate how the states can improve the competitiveness of their respective markets. PJM initially refused the requests of these two states on the grounds that studies "[do] not sit comfortably alongside PJM's core role as a neutral body, independent of any one set of constituent's interests."[10] Staff incorrectly attempts to correlate this issue with the independence of the MMU in regards to its duties within PJM. The issue of independence that is dealt with in the article referenced by Staff deals more with the ability and right of PJM to remain a neutral body amongst the states in which its footprint extends. In any event, this issue has been resolved at PJM, as the PJM MMU is currently in the process of reviewing the New Jersey and Maryland auctions.

Another significant fact that demonstrates the market's ability to support large scale procurements is the widespread participation by financial institutions and hedge funds. The 2006 Wholesale Power Sales statistics provided by *MegaWatt Daily* illustrates both the volume of sales (in Megawatt-hours or MWhs) of these market participants and their relative ranking versus other entities such as utilities, energy trading firms, etc. A number of these financial participants consistently rank at or near the top, in terms of MWh sales of electric energy. While other

[10] "PJM monitor to help 2 states scrutinize auctions," Platt's Energy Trader, September 4, 2007, p.14.

procurement participants are linked to serving the load or utilizing their own generation assets to supply power, these sophisticated financial institutions would not voluntarily participate so heavily if they did not believe the market was robust and efficient.

**D. The RTO model enables wholesale power transactions to occur from sources within or outside an RTO market and it is not constrained to the incumbent utility's generation assets.**

Staff questions (at pages 8 and 9) the amount of supply that can compete with the host utility's affiliated generation in a competitive bidding process, given that a significant amount of generation is committed to a specific load based on regulatory or other commitments. They further assume that the winning bidders in an auction would most likely be procuring the power from FirstEnergy generating units and that FirstEnergy would not sell to them at a lower price than what it could get in an annual auction. As referenced above, this position belies the fact that the market supported FirstEnergy's 2004 auction in Ohio by supporting the required load, even though FirstEnergy Solutions was not among the winning suppliers. Staff's argument also overlooks the fact that a core function of an RTO is to serve load based on the principle of a security constrained economic dispatch using all generation resources available on the grid. Both PJM and MISO bifurcate the load requirement and generation resources. In other words, the load pays the load LMP to the RTO and generation resources receive the generation LMP from the RTO. Generation is not committed to a specific load. The load is served by the least-cost blend of generating units, subject to any transmission constraints.

Staff seems to imply that the only generation resources available to serve FirstEnergy load would be their own units. While AEP cannot speak to the FirstEnergy situation specifically, the fact is that bidders have a number of options available to them to purchase power to serve load secured through a competitive bid including deliverable purchases from another RTO

market, through a bilateral contract, etc. Indeed, a primary purpose of the RTO model is to expand the grid footprint so that wholesale power purchases can be transacted within, through or into an RTO market. As mentioned previously, there has been a successful 7,200 MW auction with Ameren, another MISO utility. Illinois also conducted another successful auction with ComEd, a PJM utility, for 18,300 MW. In addition, AEP, among other companies, would be a potential bidder in the FirstEnergy auction. Based on the competitive process, participants in the auction would continue to bid, offering at a price closer and closer toward the utilities' variable cost of production.

With respect to AEP Ohio, the results from the RFP to serve the former Monongahela Power customers serves as an example of a successful process where many market-based bidders were available. The RFP resulted in twelve qualified bidders, forty-four bids received with the five lowest bids being awarded (the winning bids were within a tightly-clustered range of only 35¢). The load shape for Monongahela Power is based on the same general blend of loads as others in the PJM and MISO service territories. Although the size of the bid is not comparable to FirstEnergy load, power was procured based on awards for multiple smaller tranches providing opportunity for any market participants to secure a portion of the load to be served. This also had the effect of ensuring that a specific load is not awarded based on any single bid.

**E. The purpose of electric restructuring was not to guarantee lower prices but rather to establish market-driven prices for generation supply.**

Staff contends (at page 9) that restructuring was sold on the basis that competition would drive prices toward utilities' variable cost of production. But electric restructuring is based on the principle that retail rates will be driven toward the **market's** incremental cost of production, not the "**utility's**" variable cost of production. Although a competitive market does tend to drive prices toward cost, it is quite rare even in the most competitive markets that individual market

participants are driven to sell at their variable cost of production. Rather, a competitive market for a fungible commodity such as electricity drives prices toward the market's incremental cost of production. For example, gasoline prices may be high and well above a particular supplier's cost but it does not mean that the market is flawed. More to the point, nobody is calling for gasoline prices in Ohio to be set at Marathon Oil's variable cost of production just because it may be lower than the market clearing price. Instead, gasoline prices are very similar among participants and are largely based on the incremental price of production in the market as a whole. Those who price above that level get shut out and have to lower their prices. Those with lower costs that could support lower prices still collect the (higher) market clearing price with the additional portion contributing to recovery of fixed costs. The same is true in an RTO market in that all participants collect the market clearing price while those who submit a higher price get shut out. This is how a competitive market works and regulation is not justified where a competitive market exists. Just because a competitive market produces higher prices than some might have expected does not mean, as the Staff believes, that market is flawed or that restructuring is a failure.

There were also other major purposes of restructuring that have materialized. It was also expected that restructuring would lead to more efficient use of the current generation and transmission system. Restructuring was also expected to bring investors to the new markets who were willing to take on some of the risk inherent in generation projects. Many of these efficiencies have been realized – generation has been built, transmission projects have been proposed and new competitors have entered the market. Using these criteria, as we have mentioned earlier, competitive markets should be judged successful. Additionally, as we

referenced earlier, there is a mounting body of research that shows restructuring has resulted in significant savings to consumers.

The current slow development of base load generation is not caused by a fault in the market, or some other failure of competition. In fact, the latest wave of new generation to come on-line was motivated, in part, by price signals sent by high market clearing prices in the late 1990's. Going into this period, the region was already long on base load capacity and integrated resource planning provided for construction of peaking capacity. In addition to the price signals Independent Power Producers were receiving, these units were built at a time when the move to deregulation was almost universally embraced, the environmental attributes of natural gas were very compelling, and the supply of natural gas was forecast to be cheap and plentiful well into the future. The economics of these investments turned out to be less than expected, but the move toward deregulation spurred needed investment and shielded ratepayers from much of the risk by allowing investors to enter the market to take on that risk.

**F. Regulatory uncertainty has tempered the investment in new generation capacity, not RTO market failures.**

After criticizing the market clearing price structure of the RTO market, Staff argues (at page 10) that the same price structure was supposed to bring a significant benefit of encouraging investment in new generating capacity to serve load now and in the future. The Staff proceeds to conclude that this, too, has failed. It is not only the current price signals that are failing to spur investment, but some obstacles do exist. Given the long lead times associated with site approval, environmental impact studies, financing, and other issues critical to building new capacity, potential rate recovery including a reasonable return on investment is essential. One of the primary reasons that there has been little investment in building new capacity in Ohio is due to the lack of regulatory certainty over the time period necessary to implement new capacity (aside

from providing certainty, the content of the regulatory regime, once it is known, will also be critical).

There are markets where new investments continue to be made. The ERCOT market, with a predictable regulatory environment, has fostered a stable electricity market for new capacity. Based on the July 2007 Monthly Status Report, ERCOT was tracking 182 active generation interconnection requests totaling nearly 69,000 MW. As a comparison, at the end of June 2007, PJM had 248 active generation interconnection requests totaling 53,387 MW.

**G. The short-term RTO markets do not detract from a long-term energy auction.**

Staff speculates (at page 11) that if a market participant, such as in the proposed auction, could receive more revenue in an hourly or day-ahead market, suppliers would defer sales to these types of transactions. This would be true if a participant had perfect knowledge of the market and could precisely predict prices in these short-term markets. However, there is substantial risk in only using the day-ahead and real-time markets. One of the many lessons learned from the last ten years is the danger in hedging your obligations in only one time frame. Markets exist to promote a mix of long-term and short-term hedging. The existence of numerous contract options and the volumes that are traded demonstrate that participants are not concentrating all of there activity in one time frame, but taking advantage of risk reduction that comes from a portfolio approach. Therefore, it is not plausible that bidders would stay away from bidding in the auction solely to hold their generation for the shorter term market.

**H. The Amaranth example does not signal an RTO market failure.**

The case of a hedge fund (Amaranth Advisors LLC) allegedly manipulating the gas markets is a valid concern for regulators and all participants in a competitive market—customers, utilities, suppliers, and investors. As Staff discusses (at page 12), Amaranth has allegedly

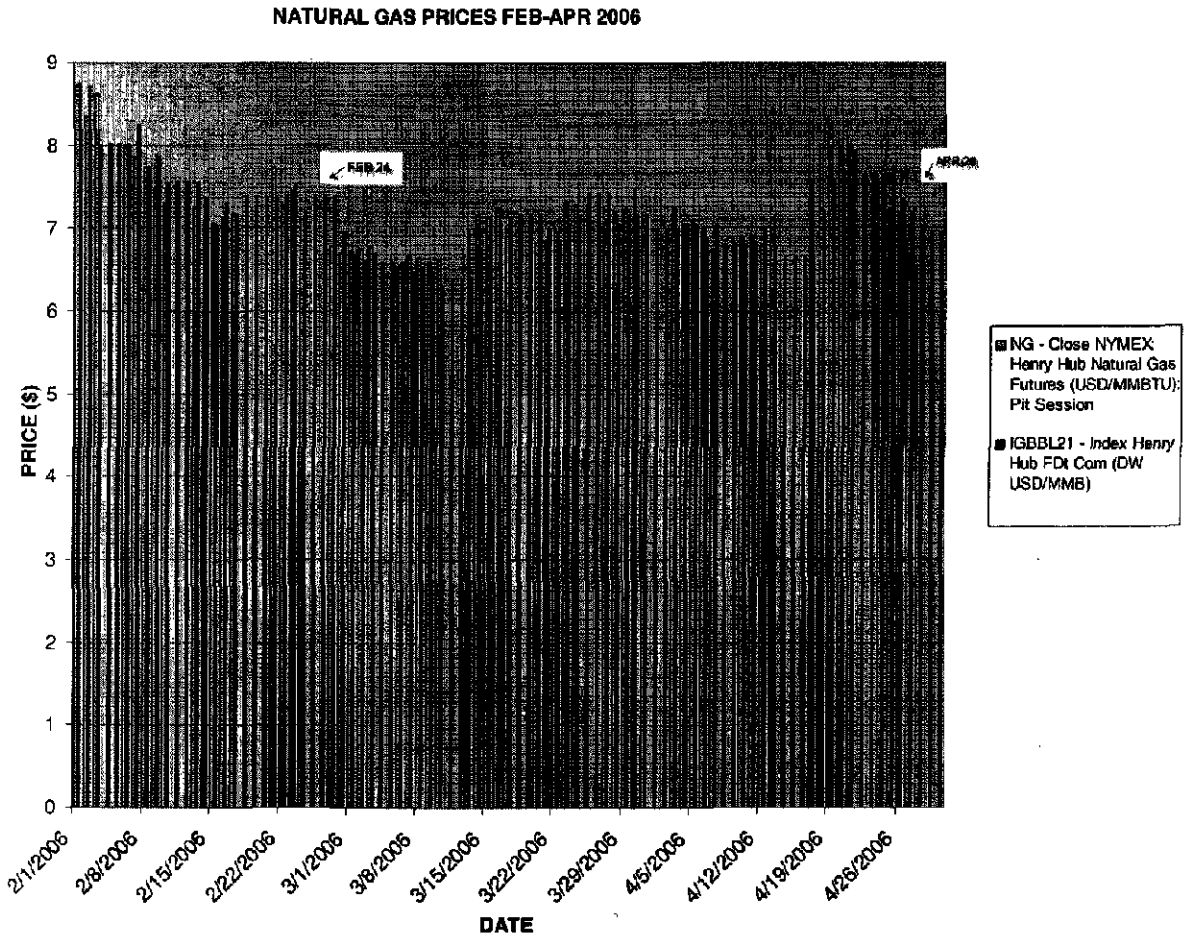
manipulated natural gas prices for hundreds of Tcf of natural gas physical and financial transactions by its actions in the last half hour of trading for the prompt month of futures contracts. Indeed, it would be an issue even in a totally regulated environment.

Preventing any sort of market manipulation is essential, but the events surrounding Amaranth can be used to illustrate that the markets are working effectively. The natural gas market functioned efficiently: prices showed very little change, trading volumes did not fluctuate dramatically, participants remained in the market, and the market absorbed the unusual trade volume. Amaranth, which lost $6 billion, has gone out of business, and is facing civil enforcement actions from the Commodity Futures Trading Commission (CFTC) and FERC, as well as from investors.

Allegedly, on the last trading days for the following month's contract (Feb 24, 2006 for the March contract, and April 26, 2006 for the May contract), Amaranth bought up an excessive amount of New York Mercantile Exchange (NYMEX) natural gas contracts. It then simultaneously maintained short positions on the Intercontinental Exchange (ICE) where prices went unreported.

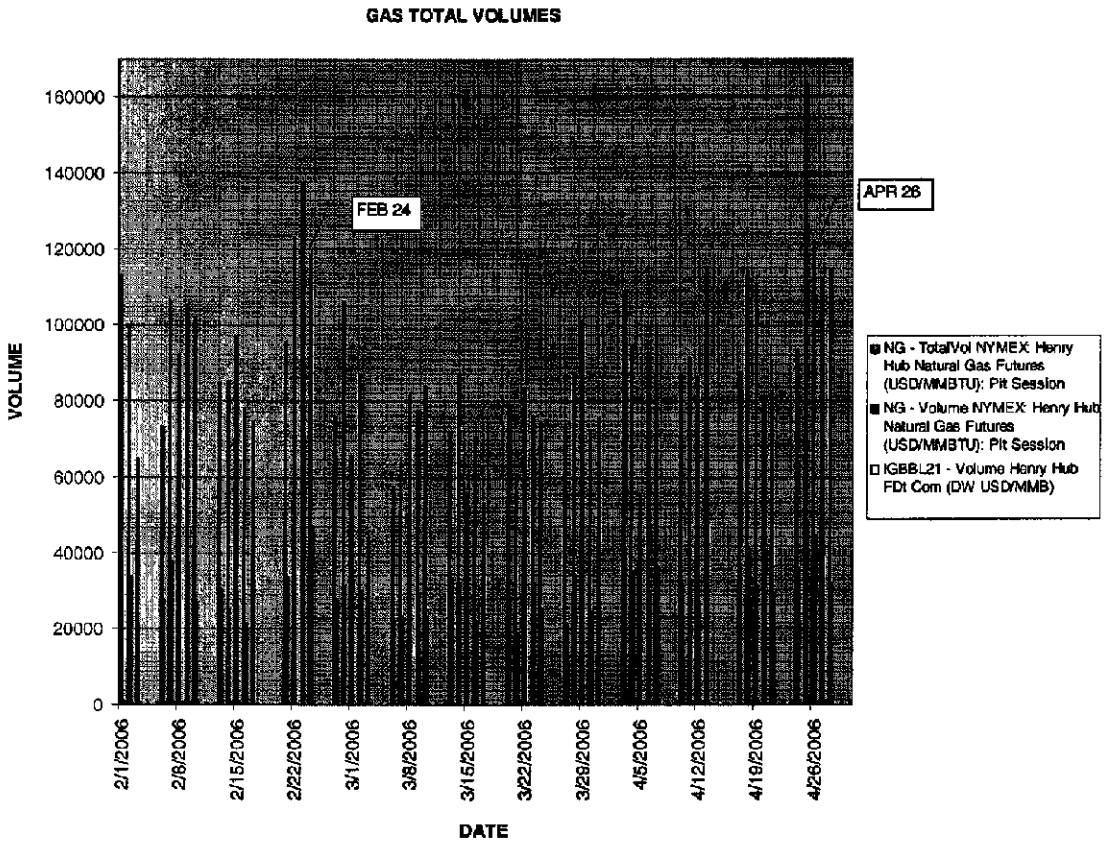
Here are some conclusions that can be drawn from the response of the market:

- Gas prices did not significantly change. The graph below shows daily closing gas prices (both NYMEX close and Henry Hub Index), for February-April 2006, with no significant deviations.




- The volume of gas traded did not significantly change. The graph below shows Total NYMEX volume with Henry Hub Futures & Volume. Suppliers and traders did not

leave the market, thus showing sufficient liquidity in the market.




- Changes have been made to the conditions that allowed trades on ICE to go unreported. By the end of 2006, ICE had implemented a large trader-reporting system related to Henry Hub natural gas markets. This brings ICE in line with the Commodities Futures Trading Commission's (CFTC's) reporting system, providing price and volume transparency.

Thus, the market activities by Amaranth Advisors show that, due to the depth of the overall natural gas market and the faith that the participants have in that market, the system resists attempts by any single participant to drive the broader market. This construct also holds true in the competitive power markets as well as other competitive markets. Although there may be times when market manipulation is attempted, the competitive market can withstand this

attempt, make necessary corrections including additional controls and oversight and continue to provide appropriate price signals.

**I. The Staff's concern about "gaming" under the repetitive procurement process is remote and speculative.**

Staff asserts (at page 12) that a repetitive procurement process invites "gaming". As stated previously, there are independent monitors associated with the auctions. The Standard NERA (also known as National Economic Research Associates) Descending Clock auction format requires a stringent Bidder Qualification and Registration process which includes multiple attestations to confidentiality among bidders. The qualification process also identifies and monitors activities by "Associated Bidders" (e.g. subsidiaries, joint-venture partners, etc.). Further, the Auction Manager quantitatively monitors the competitiveness of the auction by making volumetric adjustments to the tranches, if necessary, in between rounds. In addition, the non-winning bidders have the opportunity to refine their strategies. Plus there will likely be a large number of participants in each auction, if the experience from other states is any indicator. Therefore, the prospect of "gaming" seems highly unlikely.

**J. The PJM and MISO markets reflect liquidity.**

Staff also questions (at page 13) the liquidity in electricity markets. There are a number of possible criteria that could be used to measure liquidity. Such as the number of generation owners able to participate in an auction, the amount of transmission capability, the number of transactions, or the sum of the MWhs traded on a daily basis. Any combination of those factors would help judge the liquidity of the market. Both the PJM and MISO markets clearly satisfy these criteria.

As referenced above, virtually all of the generation produced and delivered today by EDUs in Ohio is cleared through the PJM and MISO markets. For example, last year, the total

peak load and generation in PJM was about 145,000 MW and 165,000 MW, respectively, and cleared 729,000 GWh of energy. By comparison, the PJM market clears more than four times the energy that is used by the entire State of Ohio (which utilizes approximately 190,000 GWh of energy annually). Geographically, the PJM market is also much larger than Ohio, stretching east to New Jersey, west to Illinois and south to North Carolina.

There are also numerous other examples of competitiveness in the PJM market. One of the most basic of these examples is the existence of a liquid and active financial market. Financial contracts rely on an active and transparent short-term physical market to help participants determine the value of the financial contracts being traded. Financial transactions are entered into by sophisticated participants such as hedge funds and investment banks who would not enter into those transactions if the underlying physical market was not competitive. Specifically, ICE, NYMEX and Bloomberg are active trading platforms that enable market participants to make these transactions. In PJM, financial transactions far exceed the quantity of physical transactions and serve as a strong endorsement that the PJM market is competitive.

**K. The Market Monitor has mitigated concerns about the newly-proposed MISO ancillary services market. In any event, those concerns would not carry over to the energy market.**

The Staff inaccurately claims (at page 14) that wholesale markets are premature by relying on a study performed by the MISO Independent Market Monitor which states that certain ancillary services in MISO may not pass a pivotal supplier test 100% of the time. It should be noted that MISO's Ancillary Services market is still in the stakeholder development process and approximately seven months from being implemented and the Market Monitor has proposed a mitigation framework to address this type of occurrence.

In PJM, the PJM market monitor has proposed a three pivotal supplier (3PS) test for testing market power in the PJM regulation market, an ancillary service market. The MMU has indicated that approximately 74% of the hours all companies would pass the 3PS in PJM. For those hours in which a company does not pass the 3PS test, cost caps, based on an offering party's variable production cost, are imposed on their offers.

The Staff would then improperly carry this inaccurate claim over to the energy market. Ancillary Services are but a small part of the market and are independent of the competitive wholesale capacity and energy market. As part of FERC's oversight of the PJM and MISO markets, annual reports are filed by the market monitors as to the state of the market. In 2006, the PJM Market Monitor found in its report a) that both the PJM capacity and energy markets are competitive and that rules are in place to limit the incentive for market participants to exercise market power, b) that the prices are correctly set (on average) by marginal units operating at or very close to their marginal costs, which is strong evidence of competitive behavior and competitive market performance and c) that the fuel-cost-adjusted, load-weighted, average LMP decreased by 5.6% between 2005 and 2006, which directly signals a competitive market. MISO's independent MMU, Potomac Economics, also concluded that the MISO market performed competitively in 2006.

**L. The Market Monitoring paradigm is independent and effective.**

Staff expresses uncertainty (at page 15) about the independence and effectiveness of the market monitoring paradigm. With regards to the independence of the PJM MMU, FERC has established a settlement process to respond to complaints by certain PJM market participants regarding the independence of the market monitor. This shows that wholesale markets are effectively regulated and that this oversight helps ensure improvements to the market.

The independent Brattle report issued recently on the activities of the PJM MMU actually indicated that in many cases the market monitor's tests were actually over-mitigating the market participants.

Brattle Report Comments:

- PJM's market power mitigation process relies primarily on structural tests, which prevents firms that appear to have market power from abusing this apparent power. The structural approach in practice tends to be more restrictive in that it assumes that a supplier with the ability to exercise market power also has the incentive to do so.

- The recommended best practices framework for developing mitigation processes involves a three step approach:

    1. Market power abuse is defined clearly.
    2. A transparent screening framework to detect likely abuses of market power is developed that explicitly considers the aggregate social cost of testing errors.
    3. Mitigation actions are specified based on competitive "reference levels" that take into account the reliability with which such levels can be determined.

- Mitigation actions, if they are erroneous or unnecessary can promote both short-term and long-term inefficiency. This can lead to costly changes in the operations of generating plants and distorted prices that adversely affect investment incentives, contracting behavior, demand response, innovation, and dynamic efficiency. Over-mitigation may undermine the confidence of those investing in new generation and result in higher long-term costs for consumers.

The 3PS test, currently used in PJM, is a potentially stringent test that may be susceptible to triggering over-mitigation (*i.e.*, imposing mitigation when market power abuse does not exist). The comments by PUCO Staff are premature and should be tempered until the FERC settlement conferences are concluded.

The market monitor plays a crucial role in ensuring the competitiveness of wholesale electricity markets. FERC has received additional congressional authority in policing markets. FERC's active involvement with the issues raised regarding the PJM market monitor is a strong signal of FERC's commitment to overseeing fair and efficient markets. The many studies

showing the competitiveness of PJM is a reflection of the success of the market monitor in most situations. Finally, uncertainty of the market monitor has not been shown to impact prices.

**M. The joint and common market between PJM and MISO is sufficiently developed.**

Staff raises questions (at page 16) about the joint and common market between PJM and MISO. As part of their joint common market initiative, PJM and MISO have implemented or are in the process of implementing several major elements towards achievement of a common market. Each of these markets are adequate on their own and will just get better with a joint and common market. The benefits of the initial phase of their efforts primarily were improvements in reliability and congestion management. According to the RTOs, the second phase provided considerable benefits by introducing the opportunity for one market-based RTO to request redispatch from the other market-based RTO when that option proved more economic than internal redispatch. In the Fall of 2006, MISO estimated total annualized benefits of the increased market efficiency by the second phase to be $50.5 million.

PJM and MISO also have reported that, as a result of their coordinated market efforts, the LMPs at the proxy busses on the PJM/MISO interface are converging very well. The RTOs' statistical analyses indicate that the average of the LMP differences at PJM and MISO proxy busses which reflect the market price of the two RTOs along the seams for the study period (January 1, 2006 through July 23, 2006) were less than a dollar. In a June 1, 2007 presentation made at a MISO/PJM joint stakeholder meeting, the RTOs stated that evidence of the small average differences in price at PJM and MISO proxy busses and the market's ability to respond relatively quickly to price differences demonstrated that the current market structure was performing adequately.

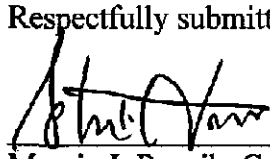
Further, on September 26, 2007, the PJM Market Reliability Committee passed a rule change which would allow PJM to utilize the same price (referred to as a "shadow price") as MISO on the shared flowgates whenever they become congested. It is expected that MISO will pass a similar rule change prior to June 1, 2008. The goal of this rule change is to bring the LMP prices of both RTOs at the shared interfaces closer together, thereby promoting participation in both markets.

As an example of how market participants view the two markets one could review the Illinois auction. This auction illustrates that many of the winning bidders were awarded load in both RTOs (PJM for ComEd and MISO for Ameren). Many of these suppliers do not have a physical presence in either RTO, but can still provide full requirements supply due to the development of the wholesale markets. The degree of correlation between two adjacent RTOs is not an impediment to competition as long as price transparency exists in each market.

## Conclusion

The Commission should reject the Staff's faulty observations and conclusions regarding the wholesale market and expand FirstEnergy's CBP proposal to include EDUs which, based on current law, will be implementing market-based rates at the conclusion of their current rate stabilization plans – including AEP Ohio.

Respectfully submitted,



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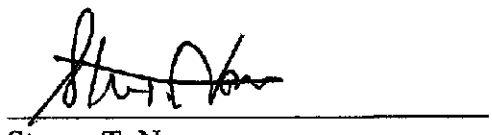
## CERTIFICATE OF SERVICE

THIS IS TO CERTIFY that a copy of the foregoing Reply Comments of Columbus Southern Power Company and Ohio Power Company was served by regular U.S. Mail, postage prepaid and electronic mail, upon each of the following parties this 12th day of October, 2007.



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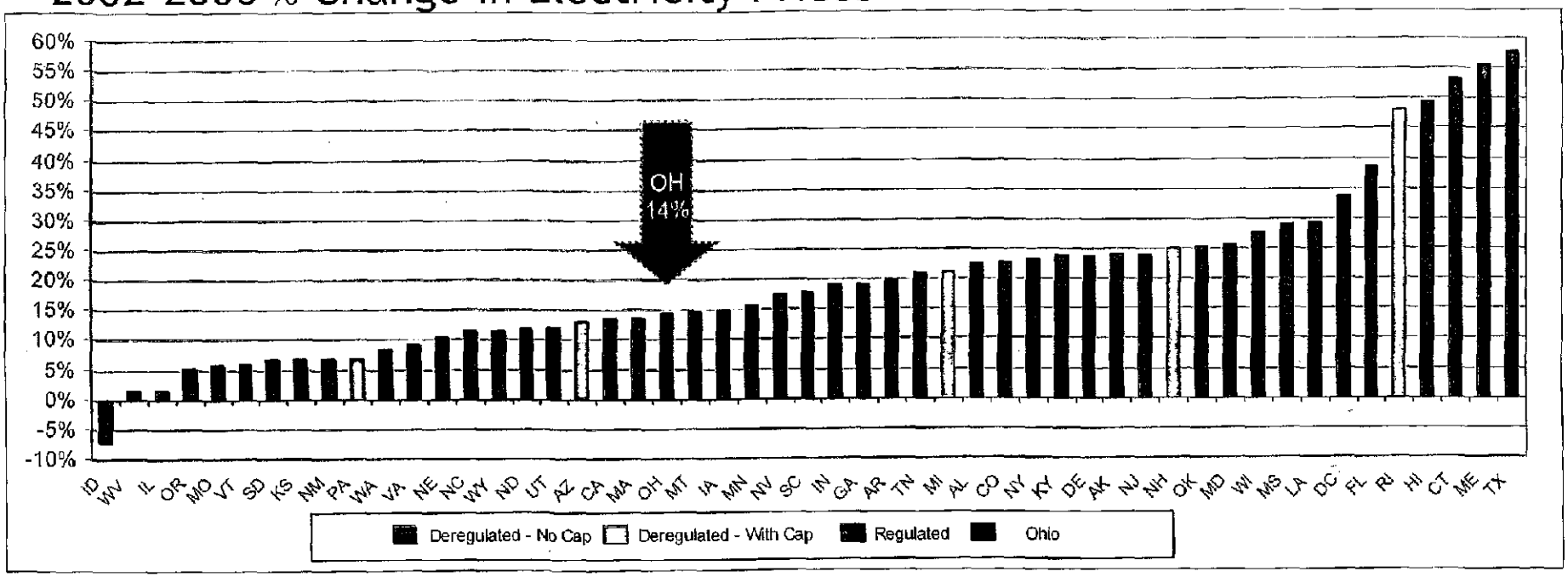
# Appendix A

# Electricity Costs Have Increased in Both Regulated and Deregulated States



## 2002-2006 % Change in Electricity Prices



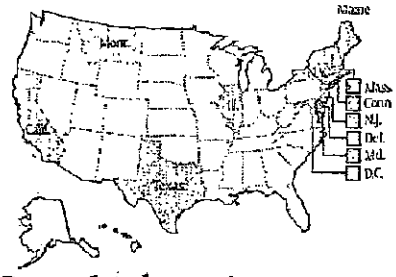

Source: USA Today, Aug. 10, 2007

- **Deregulated states median increase: 25%**
- **Regulated states average increase: 23%**
- **Ohio average increase: 14%**

[redacted]

# Electricity price shocks follow states' deregulation

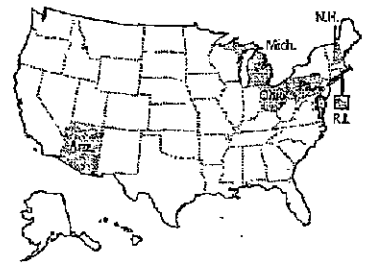
A state-by-state comparison of average residential electricity rates, in cents per kilowatt hour:




## Deregulated, no rate cap

These states no longer oversee the generation price on the utility bill and, except for California, have opened their markets to retail competition.

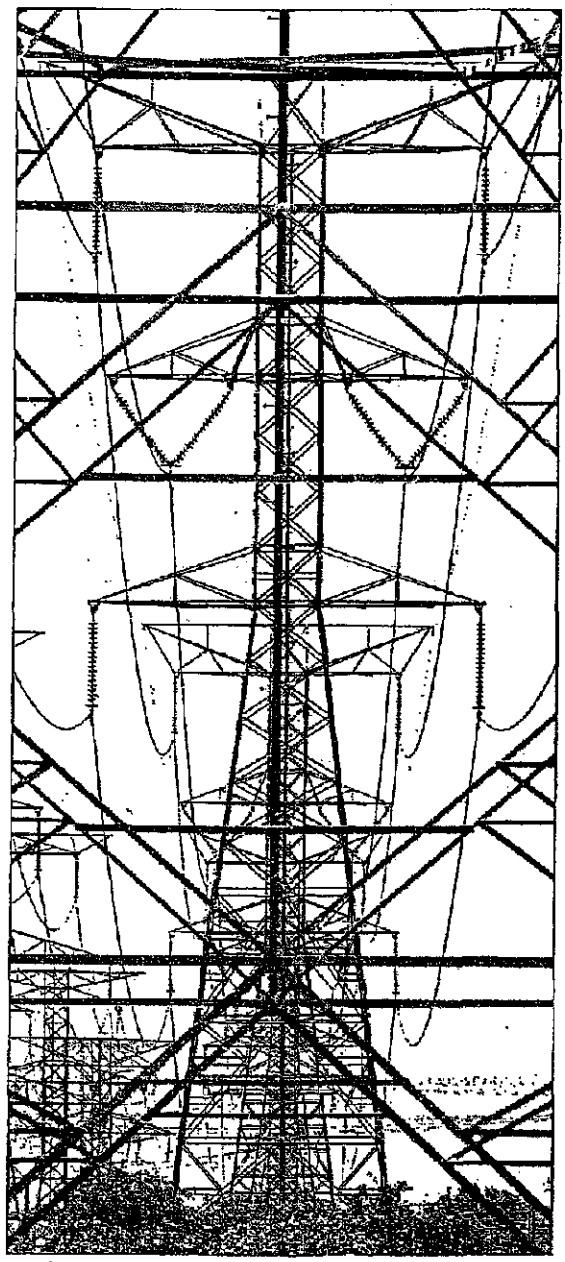
| State | 2006 price (in cents) | % change, 2002 to 2006 |
|---|---|---|
| California | 14.34 | 13.5% |
| Connecticut | 16.79 | 53.2% |
| Delaware | 11.62 | 33.6% |
| District of Columbia | 9.88 | 23.8% |
| Illinois | 8.51 | 1.5% |
| Maine | 14.47 | 13.5% |
| Maryland | 9.72 | 25.6% |
| Massachusetts | 17.01 | 55.6% |
| Montana | 8.28 | 14.5% |
| New Jersey | 12.87 | 24.0% |
| New York | 16.69 | 23.2% |
| Texas | 12.70 | 57.7% |



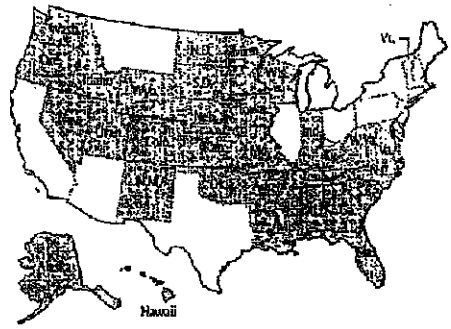

## Deregulated, with rate cap

These states still have a cap or other state oversight of utility rates but do permit retail competition.

| | | |
|---|---|---|
| Arizona | 9.35 | 13.0% |
| Michigan | 10.02 | 21.0% |
| New Hampshire | 14.85 | 24.9% |
| Ohio | 9.42 | 14.3% |
| Pennsylvania | 10.41 | 6.8% |
| Rhode Island | 15.09 | 47.9% |



Source: Ken Rose, Institute of Public Utilities at Michigan State University; photo by Tim Boyle, Getty Images; maps by Marcy Mullins, USA TODAY




## Regulated

These states must approve the rates of their utilities, which supply much of their own power and generally face no competition.

| State | 2006 price (in cents) | % change, 2002 to 2006 |
|---|---|---|
| Alabama | 8.72 | 22.4% |
| Alaska | 14.92 | 23.9% |
| Arkansas | 8.67 | 19.6% |
| Colorado | 9.04 | 22.6% |
| Florida | 11.31 | 38.6% |
| Georgia | 9.08 | 19.1% |
| Hawaii | 23.36 | 49.4% |
| Idaho | 6.12 | -7.1% |
| Indiana | 8.22 | 19.0% |
| Iowa | 9.59 | 14.8% |
| Kansas | 8.18 | 6.7% |
| Kentucky | 7.13 | 26.3% |
| Louisiana | 9.17 | 29.1% |
| Minnesota | 8.65 | 15.5% |
| Mississippi | 9.39 | 29.0% |
| Missouri | 7.47 | 5.8% |
| Nebraska | 7.42 | 10.3% |
| Nevada | 11.07 | 17.5% |
| New Mexico | 9.07 | 6.7% |
| North Carolina | 9.12 | 11.3% |
| North Dakota | 7.13 | 11.6% |
| Oklahoma | 8.43 | 25.3% |
| Oregon | 7.48 | 5.1% |
| South Carolina | 9.09 | 17.6% |
| South Dakota | 7.89 | 6.6% |
| Tennessee | 7.74 | 20.8% |
| Utah | 7.61 | 12.0% |
| Vermont | 13.54 | 6.0% |
| Virginia | 8.49 | 9.0% |
| Washington | 6.81 | 8.3% |
| West Virginia | 6.32 | 1.4% |
| Wisconsin | 10.43 | 27.6% |
| Wyoming | 7.76 | 11.4% |
| **U.S. average** | **10.40** | **23.2%** |