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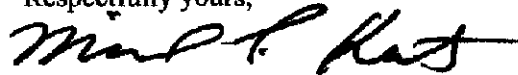
In re: Case No. 08-936-EL-SSO

Dear Sir/Madam:

Please find enclosed an original and twenty (20) copies of the BRIEF OF THE OHIO ENERGY GROUP filed in the above-referenced matter.

Copies have been served on all parties on the attached certificate of service. Please place this document of file.

Respectfully yours,



David F. Boehm, Esq.  
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**BEFORE THE  
PUBLIC UTILITY COMMISSION OF OHIO**

**IN RE: IN THE MATTER OF THE APPLICATION        )  
      OF OHIO EDISON COMPANY, THE                )  
      CLEVELAND ELECTRIC ILLUMINATING        ) CASE NO. 08-936-EL-SSO  
      COMPANY, AND THE TOLEDO EDISON           )  
      COMPANY FOR AUTHORITY TO                 )  
      ESTABLISH A STANDARD SERVICE            )  
      OFFER PURSUANT TO R.C. § 4928.142 IN       )  
      THE FORM OF A MARKET RATE OFFER        )**

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**BRIEF OF OHIO ENERGY GROUP**

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**I. COMMISSION OVERVIEW**

**A. Importance Of The MRO To The ESP**

If the Commission's goal is to implement a reasonable ESP, then the MRO alternative available to FirstEnergy needs to be as pro-consumer as allowed by law. Stated another way, if FirstEnergy faces an unattractive MRO, then it will have greater incentive to accept Commission mandated changes to the ESP.



First Energy was not required to file an MRO. But it did so in an apparent attempt to increase its ESP bargaining leverage by giving the Commission a draconian MRO alternative. But the Commission can turn the tables. FirstEnergy's reverse auction MRO should not merely be rejected for technical reasons, instead the Commission should outline precisely the type of MRO that will be mandated if FirstEnergy does not accept the Commission's ESP modifications.

The most pro-consumer MRO allowed by law was proposed by OEG and includes the following recommendations:

1. Reject the reverse auction competitive solicitation. The utilities' own witness determined that the retail risk premium (POLR risk) over and above the FERC regulated wholesale generation rate that reverse auction bidders would demand would be almost \$4 billion over three years. This amounts to \$22.86/MWH. A reverse auction benefits generation owners, like FES, not consumers. The reverse auction experience in Illinois was so bad that it has since been outlawed by separate legislation.

2. In order to reduce the \$1.33 billion annual mark-up over the FERC regulated wholesale generation rate that bidders (including FES) will demand in a reverse auction, the distribution utilities should be ordered to competitively acquire generation for non-shoppers through an actively managed portfolio of diverse wholesale generation products. The generation suppliers should only be paid the FERC regulated wholesale rate with no retail risk premium mark-up. POLR risk should be retained by the utilities at fully compensatory distribution rates set by the Commission, including the appropriate rate of return on common equity.

3. The Brattle Group has too many business relationships with FirstEnergy to be considered independent. The Commission should select the independent third party to manage the competitive generation procurement process for the utilities. The compensation paid to the Commission selected independent procurement manager should be incentive based. The better the wholesale generation price

is for non-shopping consumers, the more the procurement manager should be paid. This would inject real competition into the process.

4. For those consumers who elect to shop, non-bypassable charges should be eliminated to the maximum extent possible. The PUCO Staff correctly reached this same conclusion by recommending that all generation related charges be bypassable. This is especially true for industrial consumers. If industrial consumers are forced to shop, then economic development considerations dictate that add-ons in the form of non-bypassable charges be minimized. To do otherwise would simply make a bad situation worse.

## **B. Short Term Pricing**

The issue of timing needs to be considered. The Commission should not be rushed into a sub-optimal MRO or ESP simply because the utilities' wholesale supply arrangement with FES expires at the end of this year. A short-term plan needs to be developed. Here is our short term pricing recommendation.

If a long term ESP or MRO is not in place, the utilities should purchase energy for non-shopping customers through the MISO day-ahead market. The existing generation rates less RTCs as they naturally expire should be continued, subject to an adjustment to capture the difference between the revenues produced by the existing generation rates (less RTCs) and the total cost of MISO day-ahead purchases. This would provide the utilities with full recovery of their wholesale generation costs as required by constitutional principles.

Using published forward prices as of September 19, 2008, the cost of energy and capacity shaped for retail load in the FirstEnergy zone for the four months ending April 2009 is \$61.85/MWH. This is 20% less than the short term ESP pricing offered by FES of \$77.5/MWH. Hedging techniques can be used to lock in MISO pricing, rather than completely relying on spot market purchases. The technique of relying on the MISO day-ahead market is not new to the utilities. It is the process they recommend to acquire power if one or more of the reverse auction winning bidders defaults on its supply obligations.<sup>1</sup>

The Commission needs to put time on its side. In today's risk averse, credit starved financial markets, the prospect of having an unpredictable revenue stream beginning January 1, 2009 cannot be attractive to FirstEnergy or to Wall Street. We understand that having unpredictable rates is equally unattractive to consumers and the Commission. But the risk is mutual and the Commission need not be rushed into a long term decision.

OEG's short term pricing proposal was discussed in our ESP testimony in Case No. 08-935-EL-SSO.

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<sup>1</sup> Direct Testimony of Kevin T. Warvell at p. 14-15.

## II. ARGUMENT

### 1. The Companies' Proposed Reverse Auction Is Not An *"Open, Fair And Transparent Competitive Solicitation."*

ORC §4928.142 requires that an electric distribution utility may establish a standard service offer price for retail electric generation service that is delivered to the utility under a market-rate offer. This MRO must be determined through a competitive bidding process that provides for all of the following:

- "a) open, fair, and transparent competitive solicitation;*
- b) clear product definition;*
- c) standardized bid evaluation criteria;*
- d oversight by an independent third party that shall design the solicitation, administer the bidding; [and]*
- e) evaluation of the submitted bids prior to the selection of the least-cost bid winner or winners." (ORC §4928.142(A))*

The Companies recommend that the Commission approve its plan to set this MRO through a *"descending clock format"* otherwise known as a *"reverse auction."* In a reverse auction, the auction manager begins by soliciting bids from wholesale energy suppliers at a relatively high price. In each round of bidding wholesale energy suppliers will submit bids for the number of tranches that they wish to serve at the price *"offered"* during that round. With a high enough starting price, more than 100% of the required load would be offered by potential suppliers. As the rounds progress, the price offered decreases. Presumably, bidders not willing to sell at the decreased offered price will remove their bids. Bidding concludes when the auction arrives at a price at which the total amount offered by all bidders is equal to the amount needed by consumers. The auction is halted at this clearing price and all sellers

receive the same uniform price, even those suppliers that might have been willing to sell at a lower price.<sup>2</sup>

The Companies have failed to show that their reverse auction will result in an “*open, fair and transparent*” MRO. The Companies ignored the fact that their generation-owning affiliate may be able to influence the market clearing price by virtue of its concentration of generation ownership. The Companies’ affiliate owns the recently deregulated generation assets formerly owned by the Companies. Given the concentration of FES generating capacity in the region, it is likely that a significant portion of power bid into the reverse auction will come from the generating assets of FES. This could give FES market power and the ability to control pricing. The result would not be a fair price that reflects effective competition.<sup>3</sup>

The market clearing price can be affected by a large generation owner if the bidder pulls tranches out of the auction to artificially bring supply and demand in line. If a generator owns or controls the bulk of the generation that can be reasonably sold in the Companies’ service territories, pulling tranches at a strategic moment will be sufficient to bring demand in line with supply. This will end the auction and set the clearing price per the rules of a reverse auction. While the generation owner would lose the ability to sell its pulled tranches through the auction it would maximize profit on its remaining tranches, and be able to sell its pulled tranches to another purchaser or in a subsequent phase of the reverse auction.<sup>4</sup>

Illinois’ experience with a reverse auction is a recent example of how a newly deregulated utility can manipulate the clearing price when its generation-owning affiliate has market power. The rate increase that resulted from the Illinois reverse auction was so high that the Illinois Legislature approved

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<sup>2</sup> Direct Testimony of Kevin T. Warvell at p. 11.

<sup>3</sup> Direct Testimony of Stephen Baron at pp. 7-8.

<sup>4</sup> Direct Testimony of Stephen Baron at p. 8.

a rate relief plan banning reverse auctions less than a year after the first reverse auction took place. On January 24, 2006, the Illinois Commerce Commission authorized Commonwealth Edison and the Ameren Companies to conduct a joint reverse auction to purchase electricity to serve nearly 4.9 million customers.<sup>5</sup> The first auction took place in September 2006. It resulted in rate increases of 25 to 100 percent.<sup>6</sup>

The rate increases resulting from the reverse auction raised serious concerns regarding the reasonableness of the reverse auction process. This suspicion generated an enormous public outcry against the utilities and the Illinois Commerce Commission for approving the reverse auction. In March of 2007, the Illinois Attorney General filed a complaint with FERC alleging that ComEd and Ameren engaged in price manipulation in the reverse auction. Subsequently, a \$1 billion Rate Relief Reform Package providing refunds and credits to consumers was instituted.<sup>7</sup> The Reform Package replaced the reverse auction with a sealed-bid/negotiation process run by a new independent state agency.

The Companies' Application does not address the issue of whether there is a sufficiently competitive market to prevent its generation-owning affiliate from manipulating the auction with its market power. The Application fails to discuss market power or transmission constraints that may result in market power. There is no discussion by the Companies of the potential suppliers or bidders that have the generation resources to actually supply up to 56.5 billion kWh each year to consumers in Northern Ohio. The Application ignores the factors that could allow FES to negatively affect (raise) the clearing price at the auction.

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<sup>5</sup> Illinois Commerce Commission Administrative Case Nos. 2005-0159, 2005-0160, 2005-0161, and 2005-0162. Orders of January 24, 2006.

<sup>6</sup> Lt. Gov. Quinn Proposes Ratepayer Relief Act of 2007, ICC Member Recall Vote., Illinois Lt. Governor Press Release (February 28, 2007).

<sup>7</sup> Foster Electric Report, 7/25/07 Foster Electric Rep., 2007 WLNR 14682339.

There is cause to be concerned that the Companies' possess market dominance. First, according to Staff's Comments in the Companies' previous case requesting approval of a reverse auction, the vast majority of customers in the Companies' service territories continue to purchase default generation service and the vast majority of the few customers that do shop purchase generation from FES. This certainly suggests that FES dominates the generation market in Northern Ohio. Staff states:

*"The amount of electricity sold in Ohio by CRES providers has declined from a high of 20.5% of Ohio's total electricity requirements in 2005 to 9.0% in 2007. Of the 9.0% sold by CRES providers in Ohio 7.6% of total requirements are being served by utility affiliate marketers. Thus, non-affiliated CRES providers sold 1.3% of the total electric energy served in Ohio in the second quarter of 2007.*

*The amount of electricity sold by CRES providers in FirstEnergy service territories has declined from a high of 36.7% of total requirements in 2005 to 15.3% in 2007. Of the 15.3% sold by CRES suppliers in the FirstEnergy service territories 13.8% are being served by FirstEnergy Solutions, an affiliate of the Companies. Thus, non-affiliated CRES providers sold 1.6 % of the total electric energy consumed by customers in the FirstEnergy service territories in the second quarter of 2007."*<sup>8</sup>

Staff concludes that the retail market in the Companies' service territories might be fairly described as a "deregulated monopoly." Staff states:

*"Given the lack of customer choice in retail markets, Staff is concerned that FirstEnergy's CBP proposal would not establish a 'fall-back' option for consumers who were in the process of finding a CRES provider or switching from one CRES provider to another. Rather, it would establish the only price available to the vast majority of customers. Such a state of affairs might be characterized as deregulated monopoly. Staff is concerned that the lack of choice in the retail market would tend to influence the wholesale bidding to the disadvantage of consumers."*<sup>9</sup>

If the retail generation market continues to be dominated by FES, and there is no indication that it is not, the potential for unreasonable prices from a reverse auction would appear to be high.

The second indication that FES may have market dominance in the Companies' service territories comes from PUCO itself. On March 14, 2008 the PUCO filed comments in opposition to the

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<sup>8</sup> Case Nos. 07-796-EL-ATA, 07-797-EL-ATA. Staff Comments on the FirstEnergy Companies' Proposed Competitive Bid Process (September 21, 2007) p. 2.

<sup>9</sup> *Id.* pp 5-6.

request of FES for a grant of market based rate authority at the FERC. In these comments, the PUCO concludes that FES fails the market share analysis test. According to the PUCO, FES' determination that it passes this test is flawed because it fails to take into account the fact that all MISO uncommitted generation is not available to be delivered into the Companies' service territories. The PUCO states:

*"FirstEnergy's market power analyses are inadequate because they ignore known facts and realities. The analyses assume FirstEnergy Solutions generating resources will remain committed to the FirstEnergy operating companies despite the expiration of the contract that commits them. The analyses do not count the capacity of the Fremont Energy Facility. And, they assume that all MISO generation is available and can be delivered to compete with FirstEnergy generation when it cannot. Even if competitors' uncommitted generation is available and deliverable to compete with FirstEnergy's uncommitted generation, it may not be able to compete on the basis of price.*

*Accounting for known facts and realities significantly changes the calculus of market power for FirstEnergy. Based upon the analyses in Attachment B to this filing, Ohio has shown that when the above factors are taken into account, FirstEnergy fails the market share screen. Ohio therefore recommends the Commission require FirstEnergy to conduct a Delivered Price Screen."*<sup>10</sup>

The Commission should not approve a reverse auction process absent convincing evidence that FES does not have market dominance

**2. If The Proposed Reverse Auction Is Rejected By The Commission, The Companies' MRO Should Be Procured By A Third-Party Portfolio Manager Through A Sealed Competitive Bid Process To Achieve The Lowest and Best Price For Consumers.**

OEG recommends that the Commission reject the Companies' proposal to implement a reverse auction. Instead, the Commission should retain a third-party portfolio manager to solicit sealed competitive bids, or request for proposals, for all facets of wholesale generation supply. This would meet the statutory requirement that the *"market-rate offer shall be determined through a competitive bidding process ..."* ORC §4928.142(A)(1). The ultimate goal should be a least cost portfolio of

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<sup>10</sup> FERC Dockets Nos. ER01-1403-006, *et. al.* PUCO Request for Further Consideration and Analysis and Opposition to Request for Waiver (March 14, 2008) at p. 6.



wholesale generating resources to supply those consumers who do not shop.<sup>11</sup> OPAE witness Barbara Alexander reached a very similar conclusion. She also recommends replacing the proposed reverse auction with a diversified portfolio of generation products.

The Companies should conduct a competitive procurement using an RFP process for wholesale blocks of power and other necessary generation services to meet POLR load. Based on a reasonable mix of fixed block wholesale contracts and spot purchase and sales contracts (to deal with load following, sales forecast variation, shopping migration, etc.) the Companies would effectively absorb the retail market risk. The reasonable costs associated with these purchases to meet customer load should be recovered from customers who take POLR service, subject to Commission approval. Under this procurement approach, the Commission would have oversight on the level of the implicit "*risk premiums*" being charged to customers. The Commission would therefore have the ability to keep the retail risk premium below the \$4 billion (\$1.33 billion per year) amount estimated by Company witness Dr. Jones.<sup>12</sup>

Not surprisingly, the only party other than the utilities that supported the reverse auction was Constellation Energy. The motives of Constellation are transparent. The Constellation affiliate that owns generation would benefit from a reverse auction since it would result in higher prices and profits for their wholesale generation supply.<sup>13</sup> The high prices that would result from a reverse auction would then force more consumers to seek third party suppliers, like Constellation's retail marketing affiliate.<sup>14</sup> High generation prices may be good for Constellation's wholesale and retail businesses, but that is not good for consumers, jobs or the economy. Consumers want low rates, not multiple choices among high priced options.

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<sup>11</sup> Direct Testimony of Stephen Baron at p. 13.

<sup>12</sup> Direct Testimony of Stephen Baron at pp. 15-16.

<sup>13</sup> TE Vol. IV at 43-44.

<sup>14</sup> TE Vol. IV at 44-45.

**3. The POLR Risk Should Be Retained By The Companies And The Companies Should Be Fully Compensated For Bearing This Risk.**

The shopping risk, or POLR responsibility, should be maintained by the Companies. The Companies should be fully compensated for this risk through distribution rates set by this Commission, including an appropriate rate of return. The POLR risk should not be outsourced to the wholesale generation suppliers. A procurement process wherein the Companies obtain, via a competitive sealed bid RFP process, blocks of wholesale power, rather than full requirements service, places the risk of POLR supply on the Companies. As a result, the cost of wholesale generation should be significantly reduced.

The supplier risks inherent in a full requirements POLR service solicitation were quantified by the Companies' witness Scott Jones in the related ESP case. There, Dr. Jones explained how third parties who bid on supplying non-shopping load must factor in many different types of risk. According to Dr. Jones, when utilities out-source the responsibility and risk of generation supply to third parties through a reverse auction, the result is a mark-up over the wholesale generation price of between 17% - 40%. Keep in mind that this retail mark-up is over and above the already high FERC regulated wholesale market generation prices established through the MISO or PJM locational marginal price (LMP) process.<sup>15</sup>

Table 1 summarizes the "*margins*," in excess of the wholesale cost of generation that Company witness Dr. Jones has estimated for years 2009 through 2011 under a competitive full requirements solicitation.

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<sup>15</sup> Direct Testimony of Stephen Baron at p. 14.

**Table 1**  
**Estimated MRO Procurement Margins in Excess of FERC Regulated Wholesale Market Price\***

	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>Total</u>
Direct	\$ 4,422,960,216	\$ 4,220,202,509	\$ 4,391,580,987	\$ 13,034,743,712
Retail Margin above Market	\$ 751,974,961	\$ 1,455,254,033	\$ 1,751,336,935	\$ 3,958,565,929
Total Cost to Retail Customers	\$ 5,174,935,177	\$ 5,675,456,542	\$ 6,142,917,922	\$ 16,993,309,641

\* Source: Direct Testimony of Scott Jones, Exhibits 8, 9 and 10

As can be seen from Dr. Jones' analysis, the estimated retail "*margins*" that customers would have to pay over and above the market based wholesale generation cost are close to \$4 billion during the three year period. This is equivalent to a margin of \$22.86 per mWh. This is a very substantial payment that may be reduced if the Companies procure wholesale blocks of power, use the MISO market for load following and absorb the POLR risk themselves.<sup>16</sup>

In case No. 07-796-EL-ATA the Staff warned of FirstEnergy becoming a "*deregulated monopoly*". That fear is real. With only 1.6% of the Companies' customers actually shopping with true third party marketers, a \$1.33 billion annual risk premium to compensate for shopping risk is not reflective of efficient competition.

FirstEnergy has restructured its operations to put its Ohio generation under FERC jurisdiction. The result is market based pricing in Northern Ohio. But Ohio must guard against paying significantly more than the FERC regulated wholesale market generation rates.

<sup>16</sup> Direct Testimony of Stephen Baron at p. 15.

#### 4. The MRO Must Be Overseen By An Independent Third Party

The Companies' Application does not comply with the requirement in ORC §4928.142 that the MRO be overseen "*by an independent third party that shall design the solicitation and administer the bidding.*" The Companies propose that the "*independent third party*" that will design the solicitation and administer the bidding of the MRO will be the Brattle Group. The Companies currently employ two Principals of the Brattle Group, Frank C. Graves and Michael J. Vilbert, as expert witnesses in their ESP case. The Brattle Group has previously testified for the Companies in four prior cases before this Commission.<sup>17</sup> The Brattle Group has also testified for affiliates of the Companies in five separate proceedings before the Pennsylvania Public Utility Commission. A consulting group who's Principals have been and are currently employed by the Companies cannot be considered an "*independent third party.*" There is an inherent conflict of interest when a consultant is asked to act on behalf of his employer in one proceeding and act independently from his employer in a related, contemporaneous proceeding.

In this case a significant portion of the generation in Northern Ohio is owned by an affiliate of the distribution utilities. It is not realistic to expect the Companies to behave independently from their "*generation owning*" affiliate.

It is inappropriate for the Companies to have any role in selecting or even recommending the person or entity that will be the independent third party that will design the solicitation and administer the bidding for the MRO. ORC 4928.142 states that the administrator of the bidding should be an "*independent third party.*" A conflict of interest and an appearance of impropriety is created because of

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<sup>17</sup> Direct Testimony of Stephen Baron at p. 17.

the Companies relationship to FES. The Commission, not the utility, should find and select the independent administrator of the auction.

In addition, the Companies do not have any employee who is qualified to select an *"independent third party"* to conduct a competitive bid for wholesale generation or to build a portfolio of least cost generation resources. In their ESP Application at page 8 they state: *"the Companies do not own generation nor do their employees currently have experience in wholesale purchases, an expertise that now resides in their competitive affiliate."*

The goal of the independent administrator should be to design a competitive bid solicitation that will result in the lowest, best price for consumers, not to ensure that the Companies' generation owning affiliate secures a high price for its generation offerings. The Commission should conduct a search for a qualified, independent administrator that will be given this charge. Compensation to the independent administrator should be incentive based. The harder it negotiates with wholesale generation providers and the better the price it achieves for consumers, the more it should be paid.

#### **5. All Generation-Related Charges Should Be Bypassable**

Rider CRT is proposed to recover three costs: 1) bidding expenses not paid by third party suppliers; 2) uncollectible amounts from non-shoppers, and 3) delta revenue from any economic development schedule, energy efficiency schedule, reasonable arrangement or special contract. The first two expenses are all directly related to providing generation service to non-shopping load. Accordingly, each of the first two expenses should be bypassable by shoppers.<sup>18</sup> The third expense, delta revenue, is different. Delta revenue largely results from a policy decision of the Commission to promote some

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<sup>18</sup> Direct Testimony of Stephen Baron at p. 21.

social good, such as economic development.<sup>19</sup> Delta revenue can therefore properly be socialized to all customers, shoppers and non-shoppers alike. But it is critical that the PUCO formally approve in a separate docket each transaction that results in delta revenue. That decision cannot be left to the discretion of the Companies, pursuant to a tariff. The ability to choose winners and losers – with money from other consumers – is too much power to be vested in the Companies.

Staff witness Mr. Fortney agreed with this analysis.

*"First, I recommend that any portion of the Rider related to delta revenues be removed. The delta revenue recovery should be placed in a separate Rider and the companies should apply to recover those costs in accordance with Chapter 4901:1-38, Reasonable Arrangements. The Commission will determine the appropriate level of delta recovery in those applications. Second, after the delta revenues are removed, everything else in the Rider is related to the generation costs. I can think of no logical rationale which would require customers who are not taking generation service from the companies to pay the charges to be included in this Rider. Therefore, I recommend that Rider CRT be avoidable for those customers."<sup>20</sup>*

Even the utilities' own witness was forced to concede that the CRT recovers generation related costs.<sup>21</sup> Having made this concession, he could provide no valid reason why shopping customers should pay for generation costs twice, once from a third party supplier and again through the CRT.<sup>22</sup>

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<sup>19</sup> *Id.*

<sup>20</sup> Fortney Direct Testimony at p. 3.

<sup>21</sup> TE Vol. I at 208.

<sup>22</sup> *Id.*

### III. CONCLUSION

The strategic importance of this MRO to the ESP cannot be overlooked. In order for the Commission to have appropriate flexibility in ordering modifications to the pending ESP, FirstEnergy needs to be put on notice that an MRO will focus on consumer interests to the maximum extent allowed by law.

The Commission should also develop a short-term generation procurement strategy so that it is not rushed into a long-term decision. One viable short-term strategy is to rely on the MISO day-ahead market with hedges to lock in pricing.

Respectfully submitted,



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