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BEFORE  
THE PUBLIC UTILITIES COMMISSION OF OHIO 2009 JAN 14 PM 5:16

In the Matter of the Application of )  
Columbus Southern Power Company For )  
Approval of its Electric Security Plan )  
Including Related Accounting Authority; an )  
Amendment to its Corporate Separation )  
Plan; and the Sale or Transfer Certain )  
Generating Assets )

PUCO

Case No. 08-917-EL-SSO

and )

In the Matter of the Application of Ohio )  
Power Company for Approval of its Electric )  
Security Plan Including Related Accounting )  
Authority; and an Amendment to its )  
Corporate Separation Plan )

Case No. 08-918-EL-SSO

REPLY BRIEF OF  
THE OHIO ASSOCIATION OF SCHOOL BUSINESS OFFICIALS,  
THE OHIO SCHOOL BOARDS ASSOCIATION AND THE  
BUCKEYE ASSOCIATION OF SCHOOL ADMINISTRATORS

January 14, 2009

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**I. Introduction and Statement of Issues**

In accordance with the Attorney Examiner's procedural schedule, the following are the reply comments from The Ohio Association of School Business Officials, the Ohio School Boards Association and the Buckeye Association of School Administrators (Jointly "School Administrators"). As discussed in more detail in its Initial Brief, the School Administrators have two concerns with Application in the matter at bar. The first concern is with the design and cost of the fuel adjustment clause ("FAC") deferral. Columbus Southern Power Company and Ohio Power Company (jointly "AEP") have asked that some or all of the cost of fuel and purchased power needed to supply customers taking the Standard Service Offer during the Electric Security Plan term<sup>1</sup> be deferred and subsequently collected with carrying costs during a seven year

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<sup>1</sup> January 1, 2009 through December 31, 2011.

collection period<sup>2</sup>. AEP has further asked that the subsequent collection of the deferred fuel and purchased power be expanded to not only the customers who used the fuel and purchased power or even Standard Service customers, but all distribution customers.

The second concern of the School Administrators is the substantial increase in the Provider of Last Resort (POLR) fee AEP seeks, particularly the 742% increase for the customers of Columbus Southern Power<sup>3</sup>. The increase in the POLR fee is not to fund greater services or because AEP is experiencing greater costs in providing the POLR service, but because AEP believes the POLR service is worth more to the customers than what they are currently paying.

In the matter at bar eleven trial briefs were filed. Ten of those briefs, including the Staff of the Commission and the Office of the Consumers' Counsel, oppose both the FAC deferral and the increase in the POLR fee. Thus, this Reply Brief is limited to responding to the claims raised by AEP in its Initial Brief supporting the FAC deferral and the POLR fee increase.

## **II. ARGUMENTS**

### **A. The FAC Deferral is Not Authorized by Law, Is Unjust and Unreasonable as Applied, and Violates the State Energy Policy**

Section 4928.144, Revised Code establishes the criteria under which the Commission may authorize a phase-in of electric service costs<sup>4</sup>. First, the Commission must find that the phase-in is "necessary to ensure" rate or price stability. In its Initial Brief, AEP argues that its phase-in meets the statutory criteria because by amortizing part or all of the FAC charges out over seven years<sup>5</sup> it has "levelized" the cost<sup>6</sup>. The fact that AEP plans to delay billing customers

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<sup>2</sup> January 1, 2012 through December 31, 2018.

<sup>3</sup> School Exhibit No. 1, Direct Prepared Testimony of Mark Frye p. 6

<sup>4</sup> The portion of Section 4928.144, Revised Code which address phase-ins states: "The public utilities commission by order may authorize any just and reasonable phase-in of any electric distribution utility rate or price established under sections 4928.141 to 4928.143 of the Revised Code., inclusive of carrying charges, as the commission considers necessary to ensure rate or price stability for consumers."

<sup>5</sup> Initial Brief of Columbus Southern Power and Ohio Power, pp. 51-56.

<sup>6</sup> *Id.*

for fuel and power costs used during the 36 months of the ESP period and then collect the money back in the subsequent 84 months of the deferral collection period will indeed result in less of the fuel and purchased power being charged when the power is consumed. Merely amortizing the FAC charges however does not demonstrate why lowering the amount collected each month but extending the number of collection months is needed. Further, since the cost of the deferral is projected at \$461 million dollars<sup>7</sup>, AEP must justify why the amortization which will end up costing customers more per kWh for the fuel and purchased power consumed is worth it. The state of the record is that AEP has told us how they will defer and subsequently collect the FAC charges but not why it is necessary. The record also reveals that no customer or group of customers have asked for a deferral of part or all the FAC charges. Finally, the expert witness for the Consumers' Counsel and the Chief Economist of the Staff recommend against the deferral<sup>8</sup>.

Assuming for sake of argument that the proposed deferral was necessary for price stability, Section 4928.144, Revised Code requires that the phase-in be "just and reasonable". As presented in more detail in its Initial Brief, because many school buildings are closed in the summer they can and do purchase their generation in the open market rather than taking the Standard Service Offer generation<sup>9</sup>. In fact, most of the customers in AEP who are shopping are public schools<sup>10</sup>. Since shopping customers do not purchase generation they receive no benefit from the purchased power and generation fuel which make up the FAC. This key fact is not in

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<sup>7</sup> OCC Exhibit 10, Direct Prepared Testimony of Lee Smith, p. 24.

<sup>8</sup> *Id.* and Staff Exhibit 10, Direct Prepared Testimony of Richard Cahaan, pp. 5-6.

<sup>9</sup> See Initial Brief of the Ohio Association of School Business Officials, the Ohio School Boards Association and the Buckeye Association of School Administrators, pp. 1-3.

<sup>10</sup> Schools' Exhibit 1, Direct Prepared Testimony of Mark Frye, p. 3. Mr. Frye testifies that 386 of 408 shopping accounts are schools.

dispute and was acknowledged by AEP witness Baker<sup>11</sup>. Despite that fact, the Applicant still plans to charge shopping customers the FAC deferral charge. As a matter of equity it is unreasonable for AEP to knowingly charge customers who did not benefit or make use of the FAC the FAC deferral.

This does not mean that AEP could not have a FAC deferral. As pointed out by the Schools witness Mr. Frye, AEP could credit the customers who are shopping during the ESP the value of the FAC deferral and then charge those customers the FAC deferral<sup>12</sup>. That way the shopping customers get the benefit of the deferral as well as having to pay for it. Further, the record indicates that determining the value of the deferral for establishing a cotemporaneous credit during the ESP period is possible. In fact, AEP witness Mr. Roush provides the FAC deferral calculations by voltage level in the Application Exhibit DMRT-7 for 2009. Mr. Frye then applied Mr. Roush's per Kwh deferral charges to calculate the projected cost of the deferrals to SchoolPool members for calendar year 2009<sup>13</sup>.

Not only is it unreasonable to charge schools that procure their own generation for the fuel and purchased power used exclusively by Standard Service Customers, it also violates Section 4928.02(H), Revised Code. That statute requires the Commission to:

Ensure effective competition in the provision of retail electric service by avoiding anticompetitive subsidies flowing from a noncompetitive retail electric service to a competitive retail electric service or to a product or service other than retail electric service, and vice versa, including by prohibiting the recovery of any generation-related costs through distribution or transmission rates. (emphasis added)

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<sup>11</sup> Tr. XI, 33.

<sup>12</sup> Schools' Exhibit 1, p. 6.

<sup>13</sup> Id. at p. 4.

AEP witness Baker testified that all the cost components of the FAC are generation costs<sup>14</sup>. Further, that the FAC (if it is not deferred) is by passable for all shopping customers<sup>15</sup>. AEP however takes the position that by merely deferring the fuel and purchased power costs used to serve exclusively Standard Service Customers, it may charge FAC expenses as a wire surcharge to all customers. It should be noted that the underlined language of Section 4928.144, Revised Code quoted above was added as part of Senate Bill 221. Thus, the General Assembly clearly intended that Electric Security Plans could not be used as a vehicle to require shopping customers to subsidize standard service customers for part of their generation costs.

In addition to the provision of Section 4928.02 (H), Revised Code there is one other subsection of the Energy Policy Statute<sup>16</sup> that would be violated in spirit if not in word by permitting AEP to charge shopping customers for purchased power and generation fuel they did not consume. Section 4928.02 (D), Revised Code requires the Commission to:

Ensure diversity of electricity supplies and suppliers, by giving consumers the effective choices over the selection of those supplies and suppliers and by encouraging the development of distributed and small generation facilities. (emphasis added)

The structure of the deferral proposed by AEP to implement their phase-in would result in shopping customers not only paying for the fuel and purchased power to meet their full requirements during the ESP period, but following the ESP period they would be paying via the FAC deferral charge part of the fuel and purchased power that exclusively went to others during the ESP. School expert witness Frye quantified the impact of the FAC deferral on the current participants in the SchoolPool and projected that cost to be \$735,000. Creating a cost barrier of roughly three quarters of a million dollars for SchoolPool customers to shop impedes those

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<sup>14</sup> Id. at 36.

<sup>15</sup> Id. at 23.

<sup>16</sup> Section 4928.02, Revised Code is often referred to as the Energy Policy statute because it state that it is the energy policy of the state and then lists several subsections each of which states a goal.

SchoolPool members from having effective choice as required by the above quoted portion of the statute.

**B. The Requested Increase in POLR Fee Is Not Supported by the Record**

On the subject of establishing the proper Provider of Last Resort (POLR) fee, both AEP and the Schools in their Initial Briefs cite the testimony of witness Mark Frye for the proposition that a POLR fee is effectively “electric price supply insurance”<sup>17</sup>. Mr. Frye finds the insurance analogy apt because under the current POLR charge, established in Case No. 04-169-EL-UNC as part of the Rate Stabilization Program, a customer who shops can return to the Standard Service Offer at the then applicable Standard Service Offer price.

AEP takes Mr. Frye’s observation that the POLR acts like price insurance, and from that equates insurance to an option. The support for AEP’s increase in the POLR fee in the matter at bar then rests on premise that if the POLR is series of price options then the POLR price should be priced as if it was a generation price option<sup>18</sup>. AEP witness Mr. Baker then opines that the Black Scholes model is an options model and thus can be employed to price the POLR service<sup>19</sup>.

Pricing the POLR service based on the Black Scholes model produces a dramatic increase for essentially the same service now being provided. In its Application, AEP projects that Black Scholes priced POLR fee<sup>20</sup> in 2009 alone will increase the amount paid by all AEP customers by some \$115 million dollars<sup>21</sup> per year. To substantiate what amounts to a 742% increase in the Columbus Southern Power POLR charge and a 153% increase in Ohio Power’s

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<sup>17</sup> Initial Brief of Columbus Southern Power and Ohio Power, p. 42; Initial Brief of Schools, pp. 7-8 citing Schools’ Exhibit 1, Direct Prepared Testimony of Mark Frye, p. 7.

<sup>18</sup> Initial Brief of Columbus Southern Power, pp. 41-43.

<sup>19</sup> Initial Brief of Columbus Southern Power, p. 43-46.

<sup>20</sup> The rates themselves are set out at Companies’ Ex. 1, Direct Prepared Testimony of David M. Roush, Exhibits DMR-9, page 133 of 285 for Columbus Southern and Exhibit DMR-10 page 134 of 295 for Ohio Power.

<sup>21</sup> AEP Exhibit 2b, Direct Prepared Testimony of Craig Baker, p. 34.



POLR<sup>22</sup> charge all that is provided by AEP is Mr. Baker's testimony that compares the POLR service to a series of generation options and his calculation of how the Black Scholes option model would value the POLR service to AEP customers.

Section 4928.143 (C) (2), Revised Code places upon the utility the burden of proving all ESP rate changes. The record in the matter at bar shows that even without considering the evidence presented by the intervenors in opposition to the options model AEP has not carried its burden. AEP witness Baker could not identify any other jurisdiction where the Black Scholes model is being used to set POLR fees<sup>23</sup>. Further, AEP presented no independent witness<sup>24</sup> to substantiate the suitability of the Black Scholes model to price POLR service. Finally, Mr. Baker's testimony is devoid of any references to publications subject to peer review in which the merits of using options models in general or the Black Scholes in particular to price POLR service was reviewed and endorsed. Before the Commission authorizes customers to pay an increase in POLR fees in the range of half a billion dollars<sup>25</sup> on a pricing theory not in practice at this time an affirmative showing would have to be made that the pricing theory is sound, suitable and free of unintended ill effects.

While the record supporting the Black Scholes model as a means of pricing the POLR service rests solely on the testimony of a single company, the case against using the Black Scholes model rests on several witnesses' testimony. The School's witness Mr. Frye found several flaws with the use of the Black Scholes model to set the POLR rate<sup>26</sup>. Such as when the Black Scholes model calculates the risk upon which the option value is set it assumes all customers would switch either to the standard service or away from the standard service

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<sup>22</sup> Schools' Exhibit 1, Direct Prepared Testimony of Mark Frye, p. 6.

<sup>23</sup> Tr. XI, 224-226.

<sup>24</sup> An acknowledged expert who is not a direct employee of AEP.

<sup>25</sup> Id.

<sup>26</sup> Schools' Exhibit 1, Direct Prepared Testimony of Mark Frye, p. 7.

depending on the then current market price. Mr. Frye testified that this assumption is inaccurate because some customers may have contract obligations, such as an extended service term, that prevent the customer from switching just because of a difference in the market price to the standard service offer. Similarly, there are minimum stay provisions in the AEP tariff that could prevent switching from the standard service to a lower cost market offer<sup>27</sup>.

The Commission's Chief Economist Mr. Cahaan<sup>28</sup> expressed concern with the use of the Black Scholes model to determine a the risk of migration, because while it is relatively easy to know when an option is "in the money" the same kind of price transparency is not always available for generation contracts. That concern was also raised by Consumers' Counsel Witness Medine who also found fault with the some of the inputs to the Black Scholes model used by the AEP such as the LIBOR rate for the time value of money<sup>29</sup>.

This section began with the observation that in both the AEP and Schools Initial Briefs the POLR service was referred to as "generation price insurance". If both the Schools and AEP believe that the current POLR is supply price insurance how did they come to such different conclusions as to what the POLR price should be? The answer appears to be a difference in which party is the insured. The Schools witness believed that the POLR price insurance should be charged based on the risk and value of the POLR service to the customer. It is clear that AEP and its Black Scholes model is looking through the other end of the telescope and pricing the risk and value of the POLR service to AEP. As pointed out in Mr. Frye's testimony, AEP is charging a substantially larger POLR fee for Columbus Southern Customers than for Ohio Power customers because the price of Columbus Southern standard service is closer to the market price

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<sup>27</sup> Id. at 8.

<sup>28</sup> Staff Exhibit 10, Direct Prepared Testimony of Richard Cahaan, p. 7.

<sup>29</sup> OCC Exhibit 11, Direct Prepared Testimony of Emily Medine, p. 17.

and thus there is a greater risk of shopping. AEP does not disagree with this observation<sup>30</sup>. The greater risk of shopping however is not a customer risk it is only a risk to AEP's potential profitability when selling its competitive generation services<sup>31</sup>. If we were pricing the POLR based on the value to the customer, Columbus Southern is worth less than Ohio Power's POLR because the return price being secured for the customer is more expensive for Columbus Southern than for Ohio Power.

Since the POLR service is a utility service the conventional pricing model would be cost of service. As Mr. Frye testified though there is no demonstration by AEP that the POLR fee requested was based on an actual cost to the utility and that while AEP described the Black Scholes model as an options model, it neglected to state whether AEP plans to buy any such options<sup>32</sup>. It is clear that AEP wants to move away from cost of service and price the POLR based on it perceives the value is to the customer as an option. If that is the case then the Black Scholes model as presented in this case is fatally flawed for it is capturing the value of price insurance to AEP as a supplier, not the value of price insurance for the customer.

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<sup>30</sup> Tr. XI, 24.

<sup>31</sup> Section 4928.03, Revised Code separates competitive services which includes generation and other services determined by the Commission to be open access and non competitive services which can only be supplied by the utility.

<sup>32</sup> Id.

### III. Conclusion

WHEREFORE, the School Administrators request that the Commission reject the FAC deferral and the increase in POLR charges requested by AEP in the Application.

Respectfully Submitted,

By: \_\_\_\_\_



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## CERTIFICATE OF SERVICE

The undersigned hereby certifies that a true and accurate copy of the foregoing document was served this 14<sup>th</sup> day of January, 2009 by regular U.S. mail, postage prepaid, or by electronic mail, upon the persons listed below.



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