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THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application of Ohio	)	
Edison Company, The Cleveland Electric	)	**Case No. 07-551-EL-AIR**
Illuminating Company, and The Toledo Edison	)	**Case No. 07-552-EL-ATA**
Company for Authority to Increase Rates	)	**Case No. 07-553-EL-AAM**
For Distribution Service, Modify Certain	)	**Case No. 07-554-EL-UNC**
Accounting Practices and for Tariff Approval	)	

APPLICATION FOR REHEARING AND REQUEST FOR CLARIFICATION

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I. INTRODUCTION

Pursuant to R.C. § 4903.10 and Rule 4901-1-35 of the Ohio Administrative Code, Ohio Edison Company ("OE"), The Cleveland Electric Company ("CEI") and The Toledo Edison Company ("TE") (collectively "Companies") file their Application for Rehearing and Request for Clarification of the Commission's January 21, 2009 Opinion and Order ("Order") submitting that the Order is unlawful and unreasonable for the following reasons:

1. The Companies ask the Commission to clarify in its Order that wholesale sales revenues should not be included in the determination of the ratio used to calculate jurisdictional uncollectible expense.

    i. Related to this request, if the Commission intended to include wholesale sales revenues in the determination of this ratio, then such inclusion is manifestly against the weight of the evidence, and the Order, as it pertains to this issue, violates R.C. § 4903.09.

    ii. Related to this request, if the Commission intended to include wholesale sales revenues in the uncollectible expense ratio, then the Commission erred by incorporating the result from the use of this ratio into its determination of the Gross Revenue Conversion Factor ("GRCF").

2. The Companies ask the Commission to clarify its Order and to indicate that annualized labor expense should be based on actual data as of January, 2008.

3. The Commission's decision to remove 20% of the Companies' short-term incentive compensation expense violates R.C. § 4903.09 and is against the manifest weight of the evidence.

4. The Commission's failure to apply a full rate of return on the transition tax deferral is unreasonable and unlawful in that it deviates from Commission precedent without explanation.

5. The Commission exceeded its statutory authority when it directed the Companies to fund the Community Connections Program.

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6. The Commission's exclusion of revenue requirements related to General Plant balances violates R.C. § 4909.15 and R.C. § 4909.07 and is against the manifest weight of the evidence.

7. The Commission's decision failed to properly consider and recognize the Companies' financial risk in its determination of the cost of capital, thus resulting in an unreasonable and unlawful allowed rate of return.

8. The Commission's decision to exclude net metering customers from the requirement to pay for a dedicated telephone line is arbitrary and unduly discriminatory and, therefore, unlawful.

9. The Commission's denial of up front payments for line extension costs is unsupported by the law, the evidentiary record and a prior Commission ruling and is contrary to ratemaking principles and public policy.

II. ARGUMENTS

The Companies submit the following arguments in support of the assignments of error set forth above:

A. The Companies Ask the Commission to Clarify in its Order that Wholesale Sales Revenues Should Not be Included in the Determination of the Ratio Used to Calculate Jurisdictional Uncollectible Expense.

The Companies raised two issues regarding uncollectible expense, the second of which related to the inclusion of wholesale sales in the Commission's determination of the ratio used to allocate uncollectible expense between distribution and generation services. In the Order, the Commission addressed the first issue, but remained silent on the second. (Order, pp. 12-13.) The Companies believe that this was unintentional and ask the Commission to clarify its Order indicating its intent to exclude wholesale sales from the determination of the ratio used to allocate uncollectible expense.[1] If, on the

[1] Assuming that the Order's silence regarding the above issue was unintentional, then the impact of removing wholesale sales from the calculation of the ratio used to allocate uncollectible expense must, for purposes of consistency, flow through to the determination of the GRCF as well. The Commission's failure to make such a correction is also against the manifest weight of the evidence, thus constituting error.

other hand, the Commission intended for wholesale sales to be included in the determination of this ratio, then such inclusion is against the manifest weight of the evidence, and the Commission's Order, as it pertains to this matter, is in violation of R.C. § 4903.09.

As Mr. Ridmann testified on behalf of the Companies, the ratio should be calculated by taking a ratio of total company test year uncollectible expense to total company revenue, *exclusive of sales for resale revenue.* (Co Exh. 4-C, p. 16. (Italics added.)) In its Post Hearing Brief (at page 16), Staff agreed that the Staff's calculation "went a bit too far in that it included wholesale sales on which there are no bad debts" and endorsed the adjustment provided by Mr. Ridmann. (Id.) No party disputed either Mr. Ridmann's testimony or the Staff's acknowledgement of its error and, accordingly, the only evidence of record supports a finding that wholesale sales revenue should be excluded from total company revenue when determining the ratio used to calculate jurisdictional uncollectible expense. Moreover, since the Commission did not address this issue – something that can be corrected through clarification in an Entry on Rehearing the portion of its Order dealing with the determination of jurisdictional uncollectible expense violates R.C. § 4903.09, which requires the Commission to render an opinion "setting forth the reasons prompting the decisions arrived at ***based on*** *...findings of fact.* (Italics added.)

In light of the foregoing, the Companies ask the Commission either to (i) clarify that it intended for wholesale sales revenues to be excluded from total company revenues when determining the ratio used to allocate uncollectible expense and that such exclusion should also be factored into the determination of the GRCF; or alternatively, (ii) grant rehearing and reconsider the exclusion of such sales based on the evidence of record.

B. The Companies Ask the Commission to Clarify its Order and Indicate That Annualized Labor Expense Should be Based on Actual Data as of January, 2008.

Staff states that it prefers to use the most recent actual employee counts when determining labor expense. (Staff Br., p. 20.) The Commission concluded that the annualized employee count and related labor expense "should be based upon the most recent monthly data available." (Order, p. 14.) Yet, based upon a review of the Staff's workpapers (Schedule C-3.2 for each of the Companies), Staff based its annualized labor expense calculation on actual employee counts as of August, 2007. This data, however, is not the most current data included in the record.

In his rebuttal testimony (Co. Exh. 4-C), Mr. Kalata, testifying on behalf of the Companies, provided actual employee counts for full-time employees as of January, 2008 (Co. Exh. 4-C, Exh. JRK-7), as well as the adjustment that would be necessary if such counts were used to calculate annualized labor expense under Staff's methodology. (Co. Exh. 4-C, Exh. JRK-8.) No one, including Staff, had any questions for Mr. Kalata regarding Exhibit JRK-8.

In light of this unrebutted evidence, it is unclear why Staff continues to use the outdated August, 2007 employee levels in its labor expense calculation when more current data is available in the record. The Companies ask the Commission to clarify its Order and indicate that January, 2008 full-time employee counts should be used to determine annualized labor expense.

C. The Commission's Decision to Remove 20% of the Companies' Short-term Incentive Compensation Expense Violates R.C. § 4903.09 and is Against the Manifest Weight of the Evidence.

The Commission excluded 20%, or approximately $3.2 million,[2] of incentive compensation expense incurred by the Companies during the test year (Co. Exh. 4-C; Exh. JRK-8, pp. 1-3), finding that

> Staff has struck the proper balance regarding incentive compensation. To the extent that financial incentives are awarded for achieving financial goals, the *primary benefit* of such financial incentives accrues to shareholders. [Order, p. 17) (Italics added.]

Such a finding is arbitrary and not supported by the evidence. A review of the record indicates that Staff's only evidence -- a statement that in essence says it's a primary benefit to shareholders because we say it is -- is no evidence at all. Nowhere does Staff explain the factors it considered or how it weighed those factors when finding that shareholders were the "primary" beneficiaries of these goals being achieved. Accordingly, for the Commission to rely on such a blanket assertion without explanation or supporting analysis is improper and in violation of R.C. § 4903.09, which, as previously discussed, requires the Commission to set forth its reasoning for its decisions. Indeed, as discussed below, the weight of the evidence supports a finding that customers reap significant benefits from the achievement of these types of goals.

As already explained, Staff presented no evidence in support of its position and OCC's evidence is limited to the testimony of OCC Witness Effron who indicated that the achievement of financially driven goals provides *no* benefit to customers. (OCC Exh. 1 at 31.) Mr. Wagner, who testified on behalf of the Companies, refuted these assertions, explaining that financially driven goals are designed to create efficiencies that

[2] This amount is based on the use of January 2008 employee counts.

result in a decrease in expenses which, in turn, reduces the cost to serve customers, increases cash flow, decreases interest expense and increases earnings, all of which are common goals that benefit both customers as well as shareholders. (Co. Exh. 3-C, p. 17.) He further explained that by increasing cash inflows to the Companies, it defers the need for filing an application to increase rates and helps maintain and improve reliability – both of which are clearly significant benefits to customers. (Id.) No party rebutted any of Mr. Wagner's testimony.

In light of the foregoing, the Commission's reliance on a Staff assertion unsupported by any analysis violates R.C. § 4903.09 and is against the manifest weight of the evidence. The Commission should have included *all* of the incentive compensation expense.

D. The Commission's Failure to Apply a Full Rate of Return on the Transition Tax Deferral is Unreasonable and Unlawful in that it Deviates From Commission Precedent Without Explanation.

When applying the authorized rate of return to overall rate base in this proceeding, the Commission split rate base, applying a full rate of return to certain items, but only a debt return to "RCP Deferrals." (Order at 23.) As is discussed below, the Commission erroneously included the transition tax deferral as part of the RCP Deferrals, thus applying the wrong rate of return to the transition tax deferral.

The Commission placed into rate base the deferrals created in the Companies' Rate Certainty Plan case (Case No. 05-1125-EL-ATA ("RCP Case")). Pursuant to the stipulation approved by the Commission in the RCP Case, these deferrals earn only a debt return when placed into rate base. In the instant action, the Commission also placed into rate base the transition tax deferral that was created in the Companies' Electric

Transition case (Case No. 99-1212-EL-ETP ("ETP Case")). The stipulation approved by the Commission in that case was silent as to the return to be applied when the tax deferral was placed into rate base. While not apparent from the Order, according to Schedules A-1 and B-6 for each of the Companies in Staff's workpapers, the transition tax deferral was included with RCP Deferrals, thus applying only an embedded cost of debt return to this rate base asset. The application of only a debt return to the transition tax deferral is contrary to Commission precedent and is therefore unreasonable and unlawful.

The transition tax deferral was created through the ETP Stipulation approved in the ETP Case. While the ETP Stipulation indicated that the embedded cost of debt would be used to capitalize interest on the deferral, it made no provision for the rate of return to be applied when the deferral was placed into rate base. (Co. Exh. 3-C, p. 12.) In similar situations in the past, the Commission has always applied a full rate of return to such deferrals.[3] *See e.g., In re Ohio Edison for Authority to Establish Rates*, Case No. 89-1001-EL-AIR (Aug. 16, 1990, Opinion and Order, pp. 6, 26) (including deferred Perry O&M costs in rate base at a full rate of return); *In re Toledo Edison et al for Authority to Amend and Increase Certain Rates*, Case No. 95-299-EL-AIR (April 11, 1996 Opinion and Order, p. 19) (all rate base, including deferrals, receiving full rate of return); *In re Cincinnati Gas & Electric Co.,* Case No. 91-410-EL-AIR (May 12, 1992 Opinion and Order, p. 48) (all rate base, including deferrals, receiving full rate of return); *In re Columbus Southern Ohio Company*, Case No. 91-418-EL-AIR (May 12, 1992 Opinion and Order, p. 47) (all rate base, including deferrals, receiving full rate of return.)

[3] In contrast, however, when less than a full rate of return is intended to be applied to a deferral that is to be later placed into rate base, that intention is expressly stated. *See e.g.* Case No. 05-1125-EL-ATA, Sept. 7, 2005 Stipulation, p. 11 (deferrals when placed into rate base would be "set at the embedded cost of long term debt.")

The Ohio Supreme Court has made it clear that the Commission must respect its prior decisions absent error, saying:

> Although the Commission should be willing to change its position when the need therefore is clear and it is shown that prior decisions are in error, it should also respect its own precedents in its decisions to assure the predictability which is essential in all areas of the law, including administrative law. [*Consumers' Counsel v. Pub. Util. Comm'n* (1984), 10 Ohio St. 3d 49, 51.]

In the instant action, the Commission included the transition tax deferral as an RCP Deferral, which, in and of itself, is incorrect, given that the two types of deferrals were created in two separate cases. Moreover, the stipulation in the ETP Case which created the tax deferral was silent as to the return to be applied when the transition tax deferral was placed into rate base. Therefore, based on past Commission precedent, a full rate of return should have been applied to this deferral. The Commission's failure to do so is unreasonable and unlawful and, based on *Consumers' Counsel, supra,* also constitutes reversible error.

E. The Commission Exceeded its Statutory Authority When it Directed the Company to Fund the Community Connections Program.

The Commission adopted OCC's recommendation to increase by $5 million the Companies' funding of the Community Connections Program. (Order, p. 44.) The Commission relied on R.C. § 4928.66 in doing so. (Id.) Nowhere in this statute, however, does it provide the Commission with authority to dictate how a utility's energy efficiency program is designed. Rather, R.C. § 4928.66 requires an *electric distribution utility* "to implement energy efficiency programs that achieve energy savings (R.C. § 4928.66(A)(1)(a)), and to implement peak demand reduction programs. (R.C. § 4928.66(A)(1)(b)). And R.C. § 4928.66(A)(2)(d) indicates that "[p]rograms *implemented by a utility* may include demand-response programs, customer-sited programs, and transmission and distribution infrastructure improvements that reduce line losses." (Italics added.)

As the Ohio Supreme Court has stated on numerous occasions, the Commission, as a creature of statute, has and can exercise only the authority conferred upon it by the General Assembly. *Columbus S. Power Co. v. Pub. Util. Comm.* (1993), 67 Ohio St.3d 535; *Pike Natural Gas Co. v. Pub. Util. Comm.* (1981), 68 Ohio St.2d 181; *Consumers' Counsel v. Pub. Util. Comm.* (1981), 67 Ohio St.2d 153; *Dayton Communications Corp. v. Pub. Util. Comm.* (1980), 64 Ohio St.2d 302. Its authority under R.C. § 4928.66 is limited to verification, rulemaking and compliance.[4] Accordingly, the Commission exceeded its statutory authority when it ordered the Companies to fund a specific charity of *its* choice, thus unlawfully dictating in part the method by which the Companies comply with R.C. § 4928.66.

F. The Commission's Exclusion of Revenue Requirements Related to General Plant Balances Violates R.C. § 4909.15 and R.C. § 4909.07 and is Against the Manifest Weight of the Evidence.

The Companies discovered after the submission of their Application but before the issuance of the Staff Reports that certain general and intangible plant items, such as office furniture and equipment, communications hardware, records storage equipment and software systems, amounting to approximately $17.4 million, were inadvertently

[4] R.C. 4928.66 (A)(2)(a) authorizes the Commission to modify benchmarks; subsection (B), to annually report its findings; subsection (C), to police and penalize noncompliance; and subsections (D) and (E), to adopt rules.

excluded from plant in service balances and left on the books of FirstEnergy Service Company ("Service Company") at the time of the filing. (Co. Exh. 1-C, p. 3.)[5] At the same time, it was discovered that approximately $54 million of Service Company assets were being used to support the Companies, but that no costs associated with these assets were being allocated back to the Companies. (Id. at p. 5.) In order to remedy the situation, the Companies determined the equivalent revenue requirement impact related to both of these oversights and asked the Commission to approve an additional $2,564,920, $1,120,882 and $2,063,191 in revenue requirements for OE, TE and CEI, respectively. (Id. at 6.) No party challenged these calculations.

The Commission rejected this request for two reasons. First, it concluded that "the assets were properly excluded from the rate base because the assets were transferred back to the Companies' books after the date certain in this proceeding," agreeing with Staff that R.C. § 4909.15(A)(1) "requires that the value of the rate base must be determined at date certain." (Order at 7.) And, second, it found that "the timing of the transfer of the assets back to the books of the Companies did not allow Staff a sufficient opportunity to audit these assets." (Id.) As is discussed below, the Commission's first finding is contrary to law; its second is against the manifest weight of the evidence.

1. <u>Both Ohio law and Commission policy require the inclusion of the assets when establishing just and reasonable rates.</u>

The Companies agree that R.C. § 4909.15(A)(1) requires rate base to be valued at date certain. That, however, is not the issue. The relevant question before the Commission is whether the Companies are permitted to update the valuation of rate base

[5] The accounting entry to transfer these assets was made in January, 2008. (Co. Exh. 1-C at 5.)

after the filing of the Application. Based on both state law and Commission policy the Companies most certainly are.

R.C. § 4909.15 requires the Commission, when establishing just and reasonable rates, to determine "[t]he valuation as of date certain of the property of the public utility used and useful in rendering the public utility service for which rates are to be fixed and determined." Nowhere in this statute, however, does it limit such a determination to information provided by the Companies in their application. Rather, as R.C. § 4909.07 provides, the Commission is to keep itself informed and update such valuations:

> [T]he Commission, during the making of the valuation provided for in sections 4909.04 to 4909.13, inclusive, of the Revised Code, *and after its completion*, shall in like manner keep itself informed through its engineers, experts, and other assistants of all extensions, improvements, *or other changes* in the condition and value of the property...
>
> * * *
>
> The Commission *shall*, as is required for the proper regulation of such public utilities and railroads, *revise and correct its valuations of property*.... [Italics added.]

Clearly the goal is to factor in *all* information so as to obtain the most accurate valuation of used and useful property at date certain. In light of the foregoing, not only is the Commission *permitted* to consider information not included in an original or update filing when determining rate base valuation but, based on R.C. § 4909.07, it is *required* to do so.

The Companies presented un-refuted evidence that the assets were used and useful in rendering a public utility service at date certain.[6] Mr. Ridmann testified that the assets "were on the books of the respective Operating Companies at the time of their last rate cases, were included in the rate base in those cases, and were obviously in service as

[6] Staff claims that it did not have the opportunity to audit the assets. As is discussed *infra*, however, the evidence indicates something entirely different.

of date certain in this case." (Co. Exh. 1-C, p. 4.) Therefore, based on the evidence of record, the assets excluded from plant in service were indeed used and useful in the rendering of public utility service at date certain and should have been included in the valuation of rate base pursuant to both R.C. § 4909.15 and R.C. § 4909.07. The Commission's failure to do so is unlawful.

Similarly, Mr. Ridmann testified that the assets still on the books of the Service Company "are in fact used by employees in support of the distribution function." (Id.) No party challenged this testimony. Thus, costs associated with these assets should have been included in revenue requirements when determining the new rates.

The Commission's consideration of evidence after the filing of the application is nothing new.[7] In *In re Dayton Power & Light Co.*, Case No. 82-517-EL-AIR (Opinion and Order, April 27, 1983), the Commission considered information revealed for the first time at hearing when making an adjustment to employee counts. Its rationale was based on its recognition of the purpose underlying the test year concept:

> [T]he purpose of the test-year analysis is not to set rates for the test year, but to develop evidence of what is required to afford an applicant utility a reasonable earnings opportunity *during the period the rates will be in effect*. [Id. at 51. (Italics added.)]

There is no question that the $17.4 million of plant in service will be on the books of the Companies while rates are in effect. And there is no question that the Companies will be allocated the costs associated with the $54 million of Service Company assets used to support the Companies' business while rates are in effect. The assets were transferred and the allocated Service Company charges commenced in January, 2008 – a

[7] Indeed, the updated filing contemplated under the Standard Filing Requirements is precisely this type of post-Application supplementation of an applicant's initially-submitted data.

full year before the rates approved in this proceeding went into effect. Thus it is a foregone conclusion that the Commission's rejection of Mr. Ridmann's proposed adjustment creates a scenario unreflective of the period rates will be in effect. Not only is this in violation of the Commission's own policies, but it is also in violation of the law.

2. <u>The Commission's finding that Staff lacked a sufficient opportunity to audit all assets at issue is against the manifest weight of the evidence.</u>

The Commission also rejected Mr. Ridmann's proposed adjustment based on its finding that the Companies (allegedly) did not allow Staff a sufficient opportunity to audit the assets in question. (Order, p. 7.) As is discussed below, not only does the evidence show that Staff had adequate time to audit these assets, but it also shows that Staff, in fact, took measures to do just that. Accordingly, the Commission's finding is against the manifest weight of the evidence.

As Staff Witness Buckley conceded, the Staff was made aware of the Companies' oversights related to this issue in the Companies' response to a data request submitted on November 1, 2007. (Tr. V, p. 189.) Thereafter, Staff issued two additional data requests concerning these assets and also attended meetings with the Companies where the subject was discussed. (Id. at 189-191; Co. Exhs. 24, 25.) The initial disclosure and follow-up meetings occurred at least three weeks prior to the issuance of the Staff Reports. (*See* Tr. V. p. 190.) After the Staff Reports were filed, Mr. Buckley served another data request upon the Companies seeking additional information about the assets in question. (Tr. V, pp. 192, 193; Co. Exh. 25.)

Staff was not required to file the testimony of Mr. Buckley until January 30, 2008. Thus, as the evidence shows, Staff had all of November, 2007, all of December, 2007, and virtually all of January, 2008 to review and investigate the issue. And not only did Staff have this opportunity over this three month period, but, as the evidence clearly demonstrates, Staff *took the opportunity* and did *in fact* review the assets in question. Therefore, the Commission's finding that the Staff lacked sufficient time to investigate this matter is contrary to the record evidence.

In light of the foregoing, the Companies urge the Commission to modify its Order and include the equivalent revenue requirements as proposed by Mr. Ridmann.

G. The Commission's Decision Failed to Properly Consider and Recognize the Companies' Financial Risk in its Determination of the Cost of Capital, Thus Resulting in an Unreasonable and Unlawful Allowed Rate of Return.

Although it is not in dispute, a clear statement of the underlying financial theory is necessary to address this issue. The risk associated with a company's assets is all *business risk* if no debt is used to finance the assets. *Financial risk* is the additional risk imposed on equity holders from the use of debt in financing those assets. (Co. Exh. 8-B, p. 3.) Companies' witness Vilbert explained the concept of financial risk in detail[8] and both Mr. Cahaan and Mr. Adams agreed with the *validity* of this fundamental financial principle and the appropriateness of its consideration here. (Stf. Exh. 20, p. 27; Tr. V – 34-35.) As Dr.Vilbert stated (Tr. IX-62)[9]

> Financial risk, when a company issues debt, the debt holders get paid their interest payments first. What that means is that they take less risk than the equity holders take. The more debt you use, the more risk that's transferred then to the equity holders. And because of that the equity

[8] Co. Exh. 8, pp. 4, 10, App. E-11-15; Co. Exh. 8-B, p. 3; Co. Exh. 8-C, pp. 1-2, 6-8.

[9] The testimony of Dr. Vilbert and Messrs. Cahaan and Adams comprise the entirety of the record on cost of capital and rate of return. OSC's Mr. Solganick, although speaking to "return on equity" in his testimony, did not analyze nor present a recommendation as to cost of capital, a subject he acknowledged was outside his area of expertise. (Tr. IV– 14-16.) His actual issue focused on revenue distribution and rate design. (Opinion and Order, p. 22.)

> return that you need differs than if you had no debt or little debt, because risk is being transferred.

In the Opinion and Order, it appears the Commission also recognized the appropriateness of *considering* financial risk but, in purportedly adopting the Staff's position,[10] the Commission erroneously decided that no adjustment was necessary in order to reflect it here. Specifically, the Commission stated:

> FirstEnergy also proposed to adjust the comparable group's estimated ROE to account for FirstEnergy's financial risk. (Co. Ex. 8-B at 3-4). *Given that the market value capital structure of the comparable group is not appreciably different from the current market value capital structure of FirstEnergy* (Staff Ex. 20 at 27; Tr. Vol. VIII at 58-59[11]), *we agree with Staff and OCC that FirstEnergy has not adequately demonstrated how FirstEnergy's risk is significantly different from the comparable group to justify such adjustment.* (Staff Br. at 37-38; OCC Br. at 80-81). [Opinion and Order, p. 21 (Emphasis supplied.)]

Three problems arise in this excerpt from the Commission's decision. The first is that the Commission's characterization of the Companies' proposed adjustment is wrong (or, at best, confused). The second problem is that while the Commission *claims* it is relying on the analysis of Mr. Cahaan, it is not clear from the Opinion and Order that the Commission has relied on Mr. Cahaan's *actual* analysis at all. The third problem is that even if the Commission *had* relied on Mr. Cahaan's actual analysis, that analysis is demonstrably wrong as a matter of law and produces an unreasonable result.

The first and second of these problems are related and derive from the Commission, in its Opinion and Order, adopting a short form reference for OE, CEI, and TE, collectively, as "FirstEnergy" or, alternatively, as the "Companies," obviously

[10] OCC opportunistically joined in the Staff position on this point on brief. Mr. Adams, however, OCC's own witness, did not advocate the point.

[11] This citation in the Opinion and Order appears to have the same typographical error as was in the Staff's Initial Brief. The Companies assume the Commission's intended reference was to Tr. Vol. IX at 58-59.

intending the two terms to be equivalent and interchangeable. (Opinion and Order, p. 3.) While in many circumstances there would be no problem in the Commission adopting its own nomenclature conventions for reference purposes, the problem does arise here because the witnesses on this subject – unlike the Commission – did *not* use the terms as equivalents.[12] In particular Mr. Cahaan, whose testimony the Commission cited as the basis for its decision on the point, very clearly distinguished between "FirstEnergy" (by which he meant the aggregate FirstEnergy Corp.) and "Companies" (meaning OE, CEI and TE, the three Ohio EDU applicants in this case).[13] As a result, the Commission's terminology in the Opinion and Order does not necessarily have the same meaning as the witnesses' use of the same words in their testimony. Thus, the discussion of the issue in the above quoted excerpt of the Opinion and Order is either erroneous or, at best, ambiguous, but in either case fails to comply with the requirement of R.C. § 4903.09 that the Commission's written opinion set "forth the reasons prompting the decisions arrived at . . . ."

Specifically, as to the first problem, the Commission has either misunderstood or misstated – one cannot tell which – the Companies' position. The Companies did *not* propose, as the Commission stated, "to adjust the comparable group's estimated ROE to account for *FirstEnergy's* financial risk." The Companies' actual proposal, which Mr. Cahaan, if not the Commission, recognized, was to adjust the comparable group's estimated ROE to account *for the Companies'* financial risk (Co. Exh. 8-C, p. 7; Stf.

[12] For purposes of clarity in this Application for Rehearing, the Companies distinguish between the two terms as in the earlier briefs and as did both Dr. Vilbert and Mr. Cahaan in their testimony. "FirstEnergy" means the aggregate FirstEnergy Corp. "Companies" means the Ohio EDU applicants in this case.

[13] Specifically, and importantly, this distinction is clear in the portion of Mr. Cahaan's testimony cited in support in the Opinion and Order (i.e., Staff Ex. 20 at 27)

Exh. 20, p. 27) These are very different things, the significance of which is discussed below with respect to the third problem.

Similarly, as to the second problem, Mr. Cahaan's actual analysis was to compare *FirstEnergy's* market value capital structure to that of the comparable group. While, as discussed below, that is the wrong comparison to make, the point here is that Mr. Cahaan made clear he was referencing and considering the market value capital structure of *FirstEnergy Corp.* which, the Companies acknowledge, is not significantly different than market value structure of the comparable group.[14] The Commission, however, in the second sentence of the above quoted excerpt, refers simply to the "capital structure of FirstEnergy." This prompts the question: Did the Commission intend its use of the term "FirstEnergy" to mean FirstEnergy Corp. (Mr. Cahaan's context)? Or did it intend it to mean the Companies (which is, necessarily, the meaning which the Commission must have intended when using the same term, "FirstEnergy", in the preceding sentence)? As is the case with the first problem, discussed previously, the Opinion and Order is ambiguous.

These issues are not simply a semantic quibble or a distinction without a difference. They represent an ambiguity and confusion in the Opinion and Order which make it impossible to know "the reasons set forth for the Commission's decision", a deficiency under the requirements of R.C. § 4903.09. *MCI Telecommunications Corp. v. Pub. Util. Comm.* (1987), 32 Ohio St. 3d 306, 312. Moreover, if such ambiguity arises because the Commission has misunderstood or misstated either the record or the position

[14] Thus, the Commission's observation that the Companies had "not adequately demonstrated how FirstEnergy's risk is significantly different from the comparable group to justify such adjustment" (Opinion and Order, p. 21) may be accurate, but quite irrelevant since it has nothing to do with the adjustment the Companies actually proposed. (Co. Exh. 8-C, p. 7.)

of a party in its Opinion and Order, the problem is especially acute and rehearing is certainly required.

Apart from the deficiencies that arise under R.C. § 4903.09, however, the third problem with this portion of the Commission's Opinion and Order is that even if the Commission had unambiguously adopted the position of Mr. Cahaan in its Opinion and Order, that position cannot stand as a matter of law. In his analysis and consideration of financial risk, Mr. Cahaan decided there was no need for an adjustment because there was no significant difference between the capital structures of FirstEnergy Corp. and the comparables group. (Stf. Exh. 20, p. 27.) But that is the wrong comparison! The error in this approach is that the Commission is not setting rates or determining the required return of equity for *FirstEnergy Corp.*, it is doing so for the *Companies.* It is *the Companies'* comparative risk vis-à-vis the comparable group which must be considered. The Commission recognizes this requirement in the very next paragraph of the Opinion and Order where it states:

> As explained previously, in this proceeding *we are establishing the rate of return for three distribution electric utilities, which are regulated entities under the Commission's jurisdiction.* (Emphasis supplied.)

Why the Commission[15] elsewhere in its cost of capital analysis recognizes and adheres to this requirement, but disregards it when evaluating the impact of financial risk on the cost

[15] And, for that matter, Mr. Cahaan.

of equity capital is not only curiously inconsistent[16], it is also contrary to long-standing legal precedent. The Commission must use the Companies', not the parent's, financial metrics as it is the Companies for which the Commission is setting rates. *Federal Power Comm. v. Hope Natural Gas*, 320 U.S. 591, 603 (1944):

> "[T]he investor interest has a legitimate concern with the financial integrity *of the company whose rates are being regulated. . . .*" [Emphasis supplied.]

In addition to being unlawful, consideration of the financial risk measure of FirstEnergy Corp. rather than that of the Companies is also unreasonable in its result. Recognizing, properly, the *Companies'* financial risk rather than that of *FirstEnergy Corp.* produces a dramatically different required return on equity than that arrived at by Mr. Cahaan (or the Commission, assuming it actually intended to adopt Mr. Cahaan's analysis).

This can be readily demonstrated. Assume, *arguendo*, the appropriateness of the Commission's allowed return on equity of 10.5% in the context in which it was derived. That context reflected a financial risk or "a market value capital structure" for either the comparable group *or* FirstEnergy (i.e., FirstEnergy Corp.) – which capital structures the

[16] Both the Staff and OCC are similarly inconsistent in their focus on FirstEnergy when it comes to financial risk, but on the Companies for the other aspects of their cost of capital analysis. For Mr. Cahaan, a consideration of the FirstEnergy's capital structure in the context of financial risk comparisons is in direct conflict with his recommendation that the overall rate of return – reflecting the recommended debt cost and return on equity levels – should be based on the capital structure of the Companies, not that of the parent FirstEnergy. (Stf. Exh. 20, p. 8.) OCC, too, effectively endorsed the concept of relying upon the capital structure of the Companies rather than FirstEnergy in its argument that the differences in debt ratio – *i.e.* debt leverage, the factor which gives rise to differences in financial risk -- between CEI and TE was a reason to use separate capital structures for the two companies in arriving at an overall cost of capital. (OCC Initial Br., p. 82) Dr. Vilbert's testimony is internally consistent – and correct – in the position that it is the *Companies'* financial risk that must be taken into account. (Co. Exh. 8-C, p. 7)

Commission found to be "not appreciably different" from one another.[17] (Opinion and Order, p. 21.) Using values from Mr. Cahaan[18], the costs of capital for an entity reflecting this level of financial risk are:

	%	Cost	Weighted Cost
Debt	35	6.0%	2.10%
Equity	65	10.5%	6.83%
Overall			8.93%

If, however, we assume the same underlying business risk conditions for the Companies[19] but modify the calculation to reflect the Companies' capital structure (rather than that of the comparable group as in the prior example), the cost of capital metrics change, as they necessarily must be consistent with the undisputed financial theory:

	%	Cost	Weighted Cost
Debt	51	6.0%	3.06%
Equity	49	11.97%	5.87%
Overall			8.93%

Rather than the 10.5% return on equity deemed appropriate for entities having a financial risk reflective of the comparable group (which Mr. Cahaan likened to that of

[17] In this regard, the Commission relies on Mr. Cahaan.

[18] Mr. Cahaan assumes a market value capital structure having 65% equity. (Stf. Exh. 20, p. 27.) He relies on the tables accompanying Dr. Vilbert's testimony for a debt cost which, rounded, is approximately 6%. (*Id.*)

[19] Meaning that the overall cost of capital is held fixed at 8.93%.

FirstEnergy Corp.), the required return on equity for the financial risk metrics at the Companies' capital structure would be *11.97%*, nearly *150* basis points higher. This is a significant difference and illustrates the substantial understatement that results if an adjustment is not made to reflect the Companies' higher debt leverage (as compared with that of the comparable group or FirstEnergy Corp). While this example does not necessarily mean the Commission should have allowed 11.97% return on equity, it does demonstrate that the Commission's failure to account properly for financial risk produces an error which understates the required return on equity by a substantial magnitude and produces an unreasonable result. Rehearing is required and the Commission must employ a methodology and adopt a return recommendation which has properly accounted for the Companies' financial risk. On the record here, the only methodology and recommendation satisfying that criteria is that of Dr. Vilbert who recommended an allowed return on equity of 11.75%.

H. The Commission's Decision to Exclude Net Metering Customers From the Requirement to Pay for a Dedicated Telephone Line is Arbitrary and Unduly Discriminatory and, Therefore, Unlawful.

The Companies proposed no changes to Section VIII(D) of their Electric Service Regulations in which certain customers with parallel interconnection (whether a net-metering customer or not) provide a direct telephone line to the Companies' load dispatcher. (Co. Exh. 15-C, p. 2.) As Mr. Norris testified on behalf of the Companies, this communication link to the Companies' load dispatcher is necessary in order to communicate critical information related to safety and reliability. For example, this link allows self generating customers to notify the dispatcher when their unit is coming off line, or is operating at reduced capacity. Similarly, it allows the Companies to notify these customers of any need to either start up or shut down their units to support system reliability. (Id.)

The Staff recommended that net metering customers be exempt from this requirement. The Commission adopted the Staff's recommendation. (Order, p. 40.) Because both customers with and without net metering may have virtually identical on site generation loads, the Commission's exclusion of net metering customers from the requirement to provide a dedicated telephone line is unreasonable, arbitrary and discriminatory. In order to rectify this situation, the Companies urge the Commission to place an appropriate threshold on the requirement to provide a dedicated telephone line, regardless of whether the customer is a net metering customer, and suggest that this threshold be 100 KW. At this level, small operators, who have very little impact on the Companies' overall distribution system are exempt, while *all* large operators would come within the requirement, thus achieving the overall objective of requiring such lines on a non-discriminatory basis.

I. The Commission's Denial of Up-front Line Extension Costs is Unsupported By the Law, the Evidentiary Record and a Commission Approved Stipulation and is Contrary to Ratemaking Principles and Public Policy.

The Companies proposed to continue the up-front payments for line extensions that were established in Case No. 01-2708-EL-COI ("*Line Extension Case*".), which caused the customers requesting the line extension to directly pay a portion of the costs incurred by the Companies. (Order, p. 38.) Staff agreed with the concept but suggested a modification to the amount of the payments. (Id.) The Commission rejected the up front payment concept in its entirety, instead agreeing with the Ohio Home Builders Association ("OHBA") that line extension policies stipulated to in the Line Extension

Case were by their terms "scheduled to expire at the end of the distribution rate freeze" and opting, instead, to address a state-wide line extension policy through the current rulemaking arising under Am. Sub. Senate Bill 221. (Id. at 39.) In the interim, until new line extension rules become effective, the Companies were ordered to include all line extension expenditures in rate base. (Id.) As is discussed below, the Commission's exclusion of up-front line extension costs is contrary to the law, the evidentiary record and the stipulation approved in the Line Extension Case ("LE Stipulation") and is contrary to basic ratemaking principles and public policy.

1. <u>The Commission's rejection of an up-front payment is not supported by the law, the evidentiary record or a prior stipulation approved by the Commission.</u>

Ohio law allows recovery from individual customers for line extension services. Since such services constitute new distribution facilities, pursuant to R.C. § 4928.35(C) and R.C. § 4928.15(A), both of which include an identical provision, the customer may be required to pay all or some of the reasonable, incremental cost associated with installation:

> The schedule also shall include an obligation to build distribution facilities when necessary to provide adequate distribution service, provided that *a customer requesting that service may be required to pay all or part of the reasonable incremental cost of the new facilities,* in accordance with rules, policy, precedents, or orders of the commission. (Italics added.)

The fact that the General Assembly saw fit to provide in two separate statutes the utility's right to recover from customers "the reasonable incremental cost of new facilities" is a clear indication that the General Assembly wanted to ensure that the Companies could recover line extension costs in a timely manner so that they could continue to build distribution facilities and thus fulfill their obligation to provide adequate service. Not only does an up-front payment accomplish this goal, but it is also consistent with the Commission's Order approving the LE Stipulation and the intent of the parties.

The LE Stipulation created two separate charges, an up-front payment and a monthly surcharge. The Commission's Order approving the stipulation explains the distinction between the two, which provides the rationale for only ending the latter with the rate freeze. The Commission has viewed the up-front portion of the line extension payments as a "contribution," while viewing the monthly surcharge payment as a portion of the carrying cost. Line Extension Case, (Opinion and Order, Nov. 7, 2002, p. 37.) In approving the LE Stipulation, the Commission noted its concern for the amount of time that customers could potentially be left paying the monthly surcharge if any significant period of time passed between the end of the rate freeze period and the filing of a utility's next distribution rate case. (Id.) Thus, only the monthly surcharge is affected by the rate freeze and only the monthly surcharge should end with the rate freeze. Such a conclusion is also consistent with the intent of the parties' to the stipulation. Nowhere in either the LE Stipulation or the Opinion and Order approving the stipulation does it mention an end to the up-front line extension charges. Perhaps more telling is the fact that the LE Stipulation specifically stated that the surcharge would expire at the end of the rate freeze, but made no similar statement with regard to the up-front payment. (Line Extension Case, LE Stipulation, Section IV (A)(1)(a) and (b), p. 3.)

In light of the foregoing, the Commission's rationale for ending the up-front line extension payments is contrary to the law, its Order approving the LE Stipulation and the parties' intent.[20]

2. <u>The Commission's rejection of an up-front payment is contrary to ratemaking principles and public policy.</u>

As the Companies' witness, Mr. Ouellette, testified, an up-front payment allocates a portion of the cost to those who cause the cost. (Tr. II, p. 53.) Staff Witness Fortney agreed. (Staff Exh. 18, p. 11.) Requiring a portion of the line extension cost to be borne by those requesting the work strikes an equitable balance between the benefits derived by the individual customer and the societal benefits created through economic development. Moreover, it fulfills the promise of R.C. § 4928.15(A) and R.C. § 4928.35(C) that utilities be able to recover from customers requesting line extensions "all or part of the reasonable incremental cost of the new facilities ..." and further comports with the basic regulatory principle that costs should be charged to those who cause the costs to be incurred and those who benefit from the service. *In re Toledo Edison*, Case No. 95-299-EL-AIR (Opinion and Order, April 11, 1996, p. 70.) Further, requiring the applicant to pay an up-front cost minimizes rates. Without an up-front cost, applicants have no risk and can make representations justifying a request that may never come to fruition, thus creating abandoned infrastructure, the costs of which would have to be included in future rate base and paid by all other customers. While the up-front payment will not prevent

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[20] The evidentiary record is also unsupportive of a finding to the contrary. Neither IEU-Ohio nor OHBA sponsored testimony to support their claim that the line extension policy to require up-front payments was intended to be a "stop-gap" measure to allow a cost recovery mechanism while distribution rates were frozen, instead relying solely on their respective objections to the Staff Reports. (IEU-Ohio Objections to Staff Report, pp. 4-5; OHBA Objections to Staff Report, p. 2.)

all such situations, it will require the applicant to have a stake in the outcome and to "think twice" before making the request.

In sum, based on the foregoing, the Commission's rejection of the up-front line extension payments is contrary to public policy and basic ratemaking principles and is unsupported by the law, the evidentiary record, its prior rulings, and the intent of the parties to the LE Stipulation.

III. CONCLUSION

Based upon the foregoing, the Companies respectfully ask that their Application for Rehearing and Request for Clarification be granted.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing Application for Rehearing and Request for Clarification was served by e-mail to the following parties on this 20th day of February, 2009.

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Case No. 07-551-EL-AIR, et al.
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