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BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Fuel Adjustment Clauses for Columbus Southern Power Company and Ohio Power Company	)))	Case No. 09-872-EL-FAC Case No. 09-873-EL-FAC

PUBLIC VERSION

DIRECT TESTIMONY OF J. EDWARD HESS
ON BEHALF OF INDUSTRIAL ENERGY USERS-OHIO

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August 16, 2010 **Attorneys for Industrial Energy Users-Ohio**

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I. INTRODUCTION

Q1. Please state your name and business address.

A1. J. Edward Hess, 21 East State Street, 17th Floor, Columbus, Ohio 43215.

Q2. By whom are you employed and in what position?

A2. I am a Technical Specialist for McNees Wallace and Nurick, LLC ("McNees") providing testimony on behalf of Industrial Energy Users-Ohio ("IEU-Ohio"). IEU-Ohio is an association of commercial and industrial customers and functions to address issues that affect the price and availability of energy they need to operate their Ohio plants and facilities.

Q3. Please describe your educational background.

A3. I received a Bachelors of Business Administration degree from Ohio University in 1975 majoring in accounting. I completed the majority of Capital University's Master of Business Administration program and I have completed many regulatory training programs. I am a certified public accountant.

Q4. Please describe your professional experience.

A4. I have been employed by McNees since October 2009. In March 2009, I retired from the Public Utilities Commission of Ohio ("Commission") after 30 years of employment. My last position with the Commission was the Chief of the Accounting and Electricity Division of the Utilities Department. My duties included ensuring statutory compliance with state and federal laws, rules, regulations, and procedures governing utility regulation with the majority of that responsibility in the electric industry. I was also responsible for the operating income and rate base portions of base rates and general accounting matters in all of the utility industries.

Q5. Have you previously testified before the Commission?

A5. I have testified numerous times before this Commission, beginning in the early 1980's, as part of my responsibilities as a Commission employee.

Q6. What is the purpose of your testimony?

A6. My testimony contains recommendations that I have developed for the purpose of aligning the costs that are eligible for recovery through the Fuel Adjustment Clause ("FAC") and the benefits associated with such costs. My recommendations focus on two items identified by Energy Ventures Analysis, Inc. ("EVA") in the Audit Report for Columbus Southern Power Company ("CSP") and Ohio Power Company ("OP") (collectively, "American Electric Power-Ohio" or "AEP-Ohio"), docketed May 14, 2010. More specifically:

- I recommend that the Commission either credit the following three items against OP's deferred fuel expense which is subject to future recovery (1) the total value of the [redacted], (2) the correct value of the real property interests [redacted], (3) and the [redacted] American Electric Power Service Corporation ("AEPSC") in [redacted] resulting from the [redacted] contract buyout; or direct OP to re-price the FAC recovery mechanism to reflect the original [redacted] [redacted].

- I recommend that the $[redacted] per ton addition to the contract price for the [redacted]. The Commission should require [redacted] to refund the FAC portion of the $[redacted] per ton addition already collected from [redacted] customers.

II. [redacted] CONTRACT BUYOUT

Q7. Will you describe your understanding of the [redacted] contract buyout?

A7. Yes, my understanding is based on the information that is contained within the EVA audit report, discussions with the auditor, discussions with representatives of OP and CSP, and the responses we received to our discovery requests.

In [redacted], OP and [redacted] entered into a [redacted] contract for the supply of coal for the [redacted]. By 2007, the price for delivered coal under the contract was significantly below prevailing market prices for comparable coal. A dispute over the contract arose that the parties resolved through negotiations.

As a result of the negotiations, OP and [redacted] agreed to terminate the contract at the end of 2008 rather than allowing it to continue through the [redacted] contract period. As a result of this early termination of the contact, [redacted]. EVA notes that the buyout caused OP ratepayers to pay approximately $[redacted] more for coal during 2009 than they would have paid if OP had continued to receive coal at the price agreed to by [redacted].[1]

As part of the negotiated agreement, [redacted] and AEPSC received [redacted], the value of the [redacted] Reserve, and [redacted]. AEPSC booked the value of the [redacted] Reserve as $[redacted] million. EVA's audit report indicated [redacted].[2] EVA recommended that the Commission consider whether it would be appropriate to credit the [redacted] and a [redacted] for the [redacted] Reserve against OP's deferred fuel expense.

Q8. What is your understanding of the valuation of the [redacted] Reserve?

A8. AEPSC commissioned [redacted] to perform a mine feasibility study of the [redacted] Reserve. [redacted]. [redacted]. [redacted] [redacted]

[1] Audit Report at 1-5.

[2] Audit Report at 2-21.

[redacted]. [redacted]

Q9. How did AEPSC account for the [redacted] and the value of the [redacted] Reserve?

A9. The [redacted] and [redacted] Reserve valuation [redacted] were [redacted]. The [redacted][3]

Q10. How was the [redacted] from [redacted] accounted for?

A10. In [redacted], OP recorded this contract settlement by [redacted][4] [redacted] increase earnings.

Q11. Did OP FAC customers receive the full benefit of the [redacted] negotiation?

A11. No. The current accounting implemented by AEPSC would have FAC customers bear the total costs of the negotiation while AEPSC and OP are allowed to retain

[3] Response to IEU-Ohio Interrogatories 1-001, 1-003, 1-005, First Set. (Exhibit JEH-1).

[4] Response to IEU-Ohio Interrogatory INT-01, Second Set. (Exhibit JEH-2).

a majority of the benefits. This is because of the two different mechanisms in place during 2008 and 2009 to recover fuel costs. [redacted]. However, during 2008 OP did not have a specific fuel cost recovery mechanism to flow through these benefits to OP customers. Therefore, the [redacted] in benefits flowed through to earnings. The result of this accounting is that during 2009 and through 2011, the FAC recovery mechanism, created as part of OP's Electric Security Plan ("ESP"), will flow the higher costs of fuel obtained through renegotiated coal contracts directly to customers but only recognize a portion of the [redacted]. As noted earlier in this testimony, EVA has estimated that OP ratepayers paid approximately $[redacted] million more for coal during 2009 than they would have paid if OP had continued to receive coal at the price agreed to by [redacted].

Q12. Do you agree with EVA's recommendation that the Commission should require OP to credit [redacted] and the true value of the [redacted] Reserve against OP's deferred fuel expense?

A12. Yes, that is only one of the options that the Commission should consider to match these particular costs and benefits. OP customers experienced higher fuel costs during 2009 as a result of the [redacted] contract termination. As explained above, AEPSC's accounting subjects customers to higher costs as a result of AEPSC's agreement to [redacted] and AEPSC failed to [redacted]. It is my view that AEPSC's accounting violates the ratemaking principle that aligns the costs recoverable through rates with the benefits associated with such costs. Crediting [redacted], the value of the [redacted] Reserve, and [redacted] against the expense eligible for recovery through the FAC or the deferral is one fair and reasonable way to account for the totality of the negotiation.

Q13. If the Commission adopts this option of matching costs and benefits, what would you recommend for the valuation of the [redacted] Reserve?

A13. I believe that the valuation of the [redacted] Reserve needs further investigation. The 2010 FAC recoveries are subject to another annual audit and the deferred fuel expense for OP will not begin to be recovered until 2012. There is time to develop a reliable estimate of the value of the [redacted] Reserve and incorporate this value in the final determination of the balance that may be subject to recovery beginning in 2012. I recommend that the Commission [redacted] to make the initial adjustment but that the Commission require the 2010 FAC auditor to investigate the valuation in its next audit and that the auditor include a recommended valuation in the next audit report.

Q14. You have testified that the approach recommended by EVA is one option to match costs and benefits. What other option is available to align the benefits and the costs?

A14. As explained above, had the [redacted] as a result of the negotiations, the annual costs recoverable through the FAC would have been about $[redacted] million less. The second option would be to use the [redacted] contract to value the level of cost eligible for recovery through the FAC [redacted]. Under this option, OP would retain the value of the benefits received from [redacted] in exchange for the agreement [redacted] This second option may be more attractive from an administrative perspective since it does not require either a future auditor or the Commission to make a subsequent determination of the value of the [redacted] Reserve. If the Commission believes that avoiding subsequent issues related to the value of the [redacted] Reserve is appropriate, the Commission should direct OP to adjust the FAC recovery mechanism to re-price the coal subject [redacted] from the [redacted] at the [redacted] contract price. To offset the re-pricing, the Commission could allow AEPSC to retain the value obtained from [redacted] by not reducing the deferred fuel expense by the amount of such value.

Q15. What is your recommendation for the Commission?

A15. I recommend that the [redacted], the total value of the [redacted] Reserve, and the [redacted] be utilized to reduce the OP deferred fuel expense. The FAC mechanism approved by the Commission has resulted in accumulated deferred fuel expense for OP totaling $310,549,298 through December 31, 2009.[5] This deferral is a byproduct of the limitations that the Commission inserted into OP's ESP. If adopted, this recommendation would operate to reduce the deferred fuel expense balance. This would require the Commission to order OP to reduce the deferral by [redacted] plus any additional value that the Commission finds for the [redacted] Reserve above the [redacted]. The reduction should also include any carrying costs that have accrued on this adjustment.

If the Commission judges that it would be appropriate to avoid future issues related to the value of the [redacted] Reserve, I recommend that the Commission order OP to adjust the FAC recovery mechanism to re-price the coal subject to the [redacted] from the [redacted] contract at the [redacted] and allow AEPSC to retain the value of [redacted], the value of the [redacted] Reserve, and [redacted].

III. [redacted] CONTRACT SUPPORT

Q16. Will you describe your understanding of the [redacted] contract support?

A16. Yes, my understanding is based on the information that is contained within the EVA audit report, discussions with the auditor, discussions with representatives of OP and CSP, and the responses we received to our discovery requests.

[5] Audit Report at page 7-32.

In 2008, [redacted] asserted that it was losing money under its contract and if no relief was provided it would not meet its financial covenants. In response, AEPSC agreed to a two-prong financial package for [redacted]. AEPSC agreed to [redacted] in September 2008 and [redacted] agreed to repay AEPSC by deducting [redacted] tons beginning in 2009. AEPSC also agreed to increase the base price for the [redacted]/ton effective for [redacted]. The contract was also amended to provide AEPSC with the right to extend the contract for two three-year periods at the agreed-upon market price less [redacted]/ton. [redacted][6]

EVA observed that AEPSC's actions related to [redacted] were "carefully considered and economically evaluated." EVA also cited the history of AEPSC's relationship with [redacted] and the importance of retaining [redacted] as a supplier for [redacted].

Q17. Was the increased base price of $[redacted]/ton for the [redacted], which AEPSC agreed to, recovered through the FAC during 2009?

A17. Yes. The increased base price of $[redacted]/ton for [redacted] was recovered through the FAC during 2009. The total amount recovered by [redacted] in 2009 was $[redacted]. The $[redacted] is the [redacted]

[6] Response to IEU-Ohio Interrogatory 1-013. (Exhibit JEH-3).

[redacted] of $[redacted].[7]

[redacted].

Q18. Do you believe that AEPSC's accounting associated with the [redacted] price increase and subsequent [redacted] is appropriate for ratemaking purposes?

A18. No. The current FAC recovery mechanism only extends through 2011 assuming the current ESP is not terminated sooner. AEPSC's accounting essentially [redacted]. This improperly aligns the costs it is recovering from customers with the benefits.

Q19. How should the accommodation between [redacted] and AEPSC be reflected in the accounting for the FAC?

A19. I recommend that the Commission require [redacted] to refund the $[redacted]/ton [redacted] This would match the benefits of the accommodation with the cost.

[7] Response to IEU-Ohio 1-013, Confidential Attachment 1. (Exhibit JEH-4).

Q20. Do you believe that a carrying cost should be added to the deferred expense?

A20. No. [redacted] However, if the Commission believes that a carrying cost is necessary, the carrying cost rate should be a debt only rate consistent with several of the other carrying cost rates recently approved by the Commission.

Q21. Does this conclude your testimony?

A21. Yes.

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing *Public Version of Direct Testimony of J. Edward Hess* was served upon the following parties of record this 16th day of August 2010, *via* electronic transmission, hand-delivery or first class mail, postage prepaid.

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EXHIBIT
JEH-1
Public Version

IEU-OHIO'S INTERROGATORIES PROPOUNDED UPON COLUMBUS SOUTHERN POWER COMPANY AND OHIO POWER COMPANY CASE NO. 09-872-EL-FAC FIRST SET

INTERROGATORIES

1-001. Please provide a description and the journal entries of how American Electric Power Service Company ("AEPSC") accounted for the [redacted] made by [redacted], as described on page 2-21 of the Audit Report.

RESPONSE

The [redacted] received by Ohio Power Company (OPCo) from [redacted] were part of a settlement agreement executed [redacted] and AEPSC, as agent for OPCo. As part of this settlement agreement, OPCo [redacted], and also mineral and real property interests [redacted].

In [redacted], OPCo recorded [redacted] the [redacted] Reserve [redacted] as a [redacted], [redacted]

[redacted]

Please see **Confidential Attachment IEU, 1-001**.xls for these journal entries.

Confidential Attachment IEU 1-001.pdf

IEU-OHIO'S INTERROGATORIES PROPOUNDED UPON COLUMBUS SOUTHERN POWER COMPANY AND OHIO POWER COMPANY CASE NO. 09-872-EL-FAC FIRST SET

INTERROGATORIES

1-003. If the answer to Interrogatory #2 is affirmative, please [redacted] and supporting calculations for the [redacted] that were included in the 2009 FAC for [redacted].

RESPPONSE

[redacted] be subject to the 2009 FAC. Please see **Confidential Attachment EIU, 1-003.xls** for monthly detail.

Confidential Attachment IEU 1-003.pdf

**IEU-OHIO'S INTERROGATORIES PROPOUNDED UPON
COLUMBUS SOUTHERN POWER COMPANY
AND OHIO POWER COMPANY
CASE NO. 09-872-EL-FAC
FIRST SET**

INTERROGATORIES

1-005. If the answer to Interrogatory #4 is affirmative, please identify [redacted] and supporting calculations for the [redacted] that AEPSC plans to include in the 2010 FAC for [redacted].

RESPONSE

In [redacted], OPCo [redacted], a [redacted]. This amount is [redacted] in [redacted], and is [redacted] from the [redacted]

Please see **Confidential Attachment EIU, 1-003.xls** in response to EIU, 1-003 for supporting calculations.

EXHIBIT

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JEH-2

Public Version

CONFIDENTIAL VERSIO

IEU-OHIO'S INTERROGATORIES PROPOUNDED UPON
COLUMBUS SOUTHERN POWER COMPANY
AND OHIO POWER COMPANY
CASE NO. 09-872-EL-FAC
SECOND SET-<u>CONFIDENTIAL VERSION</u>

<u>INTERROGATORIES</u>

INT-01 Please provide a description and the journal entries of how American Electric Power Service Company ("AEPSC") accounted for the [redacted] by AEPSC to [redacted] described on page 2-21 of the Audit Report, which was [redacted] on [redacted] and [redacted] and [redacted]

<u>RESPONSE</u>

In [redacted] AEPSC, on behalf of OPCo, [redacted] upon [redacted] In [redacted] OPCo recorded this contract settlement by [redacted] and [redacted] and [redacted]

Please see Attachment IEU, 2-1 for applicable journal activity for [redacted]

Attachment IEU 2-1.xls

EXHIBIT
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JEH-3
Public Version

IEU-OHIO'S INTERROGATORIES PROPOUNDED UPON COLUMBUS SOUTHERN POWER COMPANY AND OHIO POWER COMPANY CASE NO. 09-872-EL-FAC FIRST SET

INTERROGATORIES

1-013. On [redacted] of the Audit Report, EVA reports that AEPSC agreed to increase the base price for all coal [redacted] effective January 1, 2009. Please provide what portion of the incremental cost of the $[redacted]/ton for coal [redacted] during [redacted] was recovered or deferred through the 2009 FAC [redacted]?

RESPONSE

While EVA understood the overall nature of the [redacted], [redacted] of EVA's audit report contains a few points that could be clarified. We submit the following for clarification:

For the [redacted] agreed to [redacted] $[redacted]. Whereas the audit report states that [redacted] agreed [redacted] by [redacted] in 2009.

In addition, AEPSC agreed to [redacted] to [redacted].

The impact of the [redacted] in [redacted] to the FAC is approximately $[redacted]. Please see **IEU 1-013 Confidential Attachment 1** for the workpapers supporting this figure.

Confidential Attachment IEU 1-013.pdf

Schedule to approximate [redacted] FAC share of coal inventory changes

EXHIBIT
JEH-4
Public Version