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BEFORE THE
PUBLIC UTILITIES COMMISSION OF OHIO

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| **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** |

# INITIAL MERIT BRIEF OF COLUMBUS SOUTHERN POWER COMPANY AND OHIO POWER COMPANY

## *** PUBLIC VERSION ***

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# INTRODUCTION

Volatile coal prices reaching all-time highs during 2007-2008 created the ideal circumstances for having a FAC mechanism in place. But Columbus Southern Power Company (CSP) and Ohio Power Company (OPCo), collectively, AEP Ohio or the "Companies" did not have a fuel adjustment clause (FAC) during this period. The Companies lived by the Rate Stabilization Plan (RSP), in effect from 2006 through 2008, and never sought to recover these extraordinarily high fuel costs. The intervenors in this proceeding, however, baited by an Audit Report that raised issues outside the 2009 audit period, advocate that the Commission should reach back into the RSP period and retroactively modify selected transactions that the Companies properly accounted for under Generally Accepted Accounting Principles (GAAP) during a period when fuel costs were unregulated and annual prudence reviews were not conducted. The end that justifies the means, from intervenors' perspective, is for OPCo's significant fuel under-recoveries – fully anticipated and incorporated into the Commission-approved rate cap/phase-in structure of the Companies' Electric Security Plan (ESP) – now to be substantially reduced. The result advocated by OCC and IEU is not only inappropriate and unfair, but is also unreasonable and unlawful. The Commission should decline intervenors' misguided invitation to retroactively modify the RSP and ESP agreements previously approved and implemented.

# BACKGROUND AND STATEMENT OF FACTS

## Enactment of SB 3 and Market-Based Pricing without FAC through 2008

Am. Sub. S.B. No. 3, 1999 Ohio SB 3, effective October 5, 1999 (SB 3), restructured regulation of electric utilities and introduced retail customer choice for electric generation service, largely deregulating generation service in Ohio. Rates for competitive generation service were established based on a market-based pricing. Under SB 3, the Companies established a Rate Stabilization Plan (RSP) that was in effect from 2006 through 2008. Under the Companies' RSP, there was no fuel adjustment clause or comparable mechanism and there was no guarantee that the RSP's generation rates would cover the Companies' fuel costs during the RSP term. (Case No. 04-169-EL-UNC, January 26, 2005 Opinion and Order; March 23, 2005 Entry on Rehearing) As the Auditor in this proceeding stated, the RSP term was "a period in which fuel cost recovery was not regulated." (Audit Report at 1-6.) This was the status through the end of 2008.

Thus, the Companies were "on their own" with respect to recovery of fuel costs during the RSP period of 2006 through 2008. Indeed, during the RSP term, coal prices experienced unprecedented volatility and ***tripled*** between mid-2007 and mid-2008. (Audit Report at 2-4.) During the period from 2001 through 2008 when no FAC was in effect, the Companies' shareholders bore the total risk of increased fuel costs. The Auditor verified that during 2007-2008 period, coal prices in the United States reached all-time high prices. (Tr. I at 61.) As Companies witness Rusk testified, during the non-FAC period, not only did delivered costs for coal in Ohio increase dramatically, but there was also unprecedented volatility in coal markets. (Cos. Ex. 2 at 15.) Material and volatile coal prices created ideal circumstances for having a FAC, but after AEP Ohio weathered this storm without one, intervenors now seek to "cherry pick" only certain upside results achieved by AEP Ohio under its prior rate plan.

During this extraordinary historical period of coal procurement when fuel costs were not regulated, the Companies entered into several transactions to manage coal prices while maintaining a reliable supply. Included among the procurement transactions are four transactions that have been raised in this proceeding: (1) a January 2008 settlement agreement which terminated the 20-year contract with [redacted] effective at the end of 2008 (2008 Buyout Agreement), (2) a November 2008 agreement with [redacted] for liquidated damages associated with a delivery shortfall occurring in 2008 (2008 Delivery Shortfall Agreement), (3) a 2008 agreement with [redacted] for contract support required to meet its financial covenants (2008 Contract Support Agreement), and (4) a February 2008 contract support agreement with [redacted] to help maintain the supplier's solvency through a production bonus payment and a temporary increase in the per ton price for coal (2008 Production Bonus Agreement). (Audit Report at 2-20 through 2-24.) None of these four transactions were found to be imprudent in the Audit Report. In fact, the Auditor praised AEP management for its performance in managing this extraordinarily challenging period.

**Enactment of SB 221 and the Adoption of a FAC mechanism for the Companies Starting in 2009**

Am. Sub. S.B. No. 221, 2007 Ohio SB 221, effective July 31, 2008 (SB 221), modified the method for setting standard service offer (SSO) rates for electric service and created new requirements for alternative energy, energy efficiency and peak demand reductions. On the effective date of SB 221, the Companies filed an Electric Security Plan in Case Nos. 08-917-EL-SSO and 08-918-EL-SSO ("*ESP Cases*"). In deciding the *ESP Cases*, the Commission adopted a FAC mechanism for AEP Ohio, concluding as follows:

> The Commission believes that the *establishment of a FAC mechanism as part of an ESP is authorized pursuant to Section 4928.143(B)(2)(a), Revised Code, to recover prudently incurred costs associated with fuel,*

> including consumables related to environmental compliance, purchased power costs, emission allowance, and costs associated with carbon-based taxes and other carbon-related regulations. Given that the FAC mechanism is authorized pursuant to the ESP provision of SB 221, *we will limit our authorization, at this time, to the term of the ESP*.
> * * *
> Therefore, we find that the FAC mechanism with quarterly adjustments *as proposed by the Companies*, as well as an *annual prudency and accounting review recommended by Staff*, is reasonable and should be approved and implemented as set forth herein.

(*ESP Cases*, Opinion and Order at 14-15 (emphasis added).) Hence, the Commission approved the proposed FAC mechanism, pursuant to the new law that had been enacted for rate plans beginning January 1, 2009 (SB 221), for prospective operation during the term of the ESP (*e.g.*, the scope of the approved FAC was confined to begin in 2009 and end after 2011), with annual prudence reviews during the term of the FAC. The holding that the adopted FAC mechanism was strictly limited to the ESP term was reinforced in the entry initiating the RFP for the audit and again in the entry selecting the auditor for this proceeding. (*See* Case Nos. 09-872-EL-FAC and 09-873-EL-FAC, November 18, 2009 Entry at 1; ("The Commission limited its authorization of the fuel adjustment clause provisions to the term of the ESP."); January 7, 2010 Entry at 1 (same).)

In order to make the transition from a period where fuel costs were not regulated to an active FAC, the Commission needed to establish a FAC baseline to unbundle CSP's and OPCo's generation rates into fuel and non-fuel components. The Commission weighed the evidence carefully and found that a proxy is appropriate to establish a baseline, adopting Staff's method of using actual 2007 fuel costs and adjusting by 3% and 7% for CSP and OPCo, respectively. (*ESP Cases*, Opinion and Order at 19.) On rehearing in the *ESP Cases*, the parties again advanced their positions and the

Commission reiterated that it had fully considered the evidence and would not change its decision.

> [B]ased on the evidence presented in the record, the Commission determined that a proxy should be used to calculate the appropriate baseline. After making this determination, the Commission reviewed all evidence in the record and all parties' arguments, and adopted Staffs methodology and resulting value as the appropriate FAC baseline.

(*ESP Cases*, Entry on Rehearing at 6.)

Thus, the key FAC issues adjudicated and decided in the *ESP Cases* were that: (1) the FAC mechanism would be limited to the ESP period, excluding both the pre-ESP period and the post-ESP period; (2) annual prudence review of fuel costs would be conducted for fuel costs incurred in 2009, 2010 and 2011; and (3) the FAC baseline was set as a one-time determination to put the pre-ESP period fuel costs in the past and transition the Companies from a non-FAC period to an active FAC period. In short, establishment of the FAC baseline and other matters involving operation of the FAC mechanism during the ESP were hotly contested issues that the Commission fully adjudicated and decided in the *ESP Cases*. Notably, in establishing the FAC baseline and strictly confining the scope of the FAC mechanism to the ESP term, the Commission was explicitly aware at that time of the volatile coal prices and extraordinary coal procurement activities that occurred in 2008 in reaching its decision regarding the FAC baseline. (*ESP Cases*, Entry on Rehearing at 5.)

**Current FAC Audit Proceeding**

In its January 7, 2010 Entry in this proceeding, the Commission selected Energy Ventures Analysis, Inc. (EVA) to conduct the three annual FAC audits during the term of the modified ESP. EVA subcontracted with Larkin & Associates PLLC to conduct the financial audit and the Audit Report was filed on May 14, 2009. The Commission held an evidentiary hearing on August 23 and 24, 2010, during which the Auditors sponsored the Audit Report and were subjected to cross examination and the Companies presented their testimony concerning the issues raised in the Audit Report. Companies witness Timothy M. Dooley, Director of Energy Accounting and Reporting within the American Electric Power Service Corporation (AEPSC), presented testimony regarding OPCo's accounting associated with the 2008 Buyout Agreement and the 2008 Production Bonus Agreement. (Cos. Ex. 1.) Next, Companies witness Jason T. Rusk, Director, Eastern Fuel Procurement for AEPSC, presented testimony regarding the several Audit Report recommendations, including addressing the background and prudence of the 2008 Buyout Agreement, the 2008 Delivery Shortfall Agreement, the 2008 Contract Support Agreement and the 2008 Production Bonus Agreement. (Cos. Ex. 2.) Companies witness Phillip J. Nelson, Managing Director of Regulatory Pricing and Analysis in the Regulatory Department of AEPSC, also testified concerning multiple Audit Report recommendations, including whether the Commission should modify any of the 2008 transactions referenced above. (Cos. Ex. 3.) Companies witness Peggy I. Simmons, Manager of Renewable Energy for AEPSC, testified concerning AEP Ohio's strategic plan for renewable energy. (Cos. Ex. 4.) After OCC witness Duann and IEU witness Hess testified, Companies witnesses Dooley, Rusk and Nelson filed rebuttal testimony in further support of the Companies.

# ARGUMENT

## PART ONE: MANAGEMENT PERFORMANCE AUDIT AND RELATED ISSUES

**Management Audit Recommendation #1 [Audit Report at 1-6] "EVA believes that the PUCO should review whether any proceeds from the Settlement Agreement should be a credit against OPCO's FAC under-recovery. This buy-out is somewhat unique as it occurred during a period in which fuel cost recovery was not regulated yet the entire value received was for tons that would have been shipped during the ESP period."**

### A. The scope of M/P Audit Recommendation #1 as clarified by Auditor

The explicit language of Management Audit Recommendation #1 is limited to deciding whether proceeds from the 2008 Buyout Agreement should be used to offset OPCo's under-recovery of fuel costs in 2009. (Audit Report at 1-6.) The proceeds of the 2008 Buyout Agreement include $[redacted] million (made in three equal payments) and a coal reserve asset located in [redacted] known as the [redacted]. A substantial portion of the $[redacted] million – being $[redacted] million – was already credited, in part, against 2009 fuel costs flowed through the FAC with the other portion to be credited against 2010 fuel costs to be flowed through the FAC. (Cos. Ex. 1 at 4.) The present value of the undeveloped, un-permitted coal reserve is simply not known. But the coal reserve is an OPCo asset that ratepayers have no claim upon. (*See* argument below in Section C.6.) As an additional matter of clarification, the Auditor also clarified that the separate 2008 Delivery Shortfall Agreement was not part of the "equity" issue she raised in recommendation #1. (Tr. I at 30.)

Moreover, the Auditor clarified that EVA was not making a recommendation but merely felt that the issue should be raised for the Commission's consideration:

> I think if AEP wanted to transfer the value of the [redacted] to the customers, then it certainly would have the right to do that. So I'm not making a judgment as to what it does with the reserve. I'm simply making a judgment that the value associated with the reserve should be considered to be applied to the underrecovery.

(Tr. I at 38.) IEU Counsel also stated on the record that the Auditor was not recommendation in this regard. (Tr. I at 51.) Whereas, OCC witness Duann interpreted M/P Audit recommendation #1 as the Auditor recommending that a regulatory remedy be implemented but that EVA simply did not recommend a specific dollar amount. (Tr. II at 202-203.) He disagreed that the Auditor had not recommended a reduction of OPCo's fuel under-recovery and indicated if he is wrong about that (which he is), it would change the opinions in his testimony. (Tr. II at 203.) Since he was wrong about that, it is not clear what his opinion would actually be.

Overall, the Audit Report provides a positive assessment of AEPSC's performance by categorically concluding (at 1-4) that "AEPSC did an exceptional job during this period particularly with those suppliers that faced financial hardship." In any event, it is clear that the intervenor testimony goes well beyond the initial question raised about the 2008 Buyout Agreement proceeds. As explained in detail below, while EVA may have had good intentions in raising this "equity" issue, it would be inappropriate for the Commission to entertain the notion because it creates a host of legal issues and undermines the regulatory compact created by AEP Ohio's current and prior rate plans.

### B. The Positions of IEU and OCC

The OCC and IEU have reacted to M/P Audit Recommendation #1 by adopting positions that not only expand the scope of the question raised by the Auditor but are unreasonable and unlawful. IEU witness Hess sponsored IEU's two-tiered position at hearing. First, IEU invites the Commission to reach outside of the 2009 Audit Period and "clawback" value from the 2008 Settlement Agreement and the 2008 Delivery Shortfall Agreement to reduce OPCo's current ESP fuel deferrals and fulfill a "ratemaking principle that aligns the costs recoverable through rates with the benefits associated with such costs." (IEU Ex. 1 at 7.) Thus, Mr. Hess advocates using unprecedented regulatory asset accounting to retroactively modify accounting transactions already properly booked under GAAP during the period when AEP Ohio's fuel costs were unregulated. Second, IEU argues that the Commission should also "claw forward" to presently quantify potential value associated with a 2013 coal purchase option under the 2008 Contract Support Agreement, to further reduce OPCo's current ESP fuel deferrals and "match the benefits of the accommodation with the cost." (*Id.* at 11.) As further discussed below, OPCo submits that IEU's proposal lacks any basis in GAAP and that it is otherwise inappropriate to use regulatory accounting to "prefund" for customers a future coal discount option that may never be used.

Mr. Hess indicated that he was not making an issue of the Companies' GAAP accounting or FERC accounting; rather, he stated that he is making a "ratemaking" recommendation that is not based on accounting at all. (Tr. II at 246, 251.) Mr. Hess initially claimed that OPCo had an option in 2008 to create a regulatory liability but then went on to repeatedly acknowledge that Commission approval would have had to be obtained. (Tr. II at 247, 250-252.) To achieve this result, Mr. Hess awkwardly suggested that OPCo could have "requested an application for an accounting modification with the Commission to account for it as a regulatory liability and then have flowed that through properly to the FAC customers." (Tr. II at 247.) He then stated that the applicable statute in 2008 required rates to be market-based – not cost-based – and went on to admit that one of the controlling criteria for creating a regulatory asset is that the company would have to be cost regulated. (Tr. II at 248, 250.) Aside from not being cost regulated for fuel during this period, there is also the obvious fact that OPCo did not have "FAC customers" in 2008. As further discussed below, there is no getting around the fact that Mr. Hess' recommendation amounts to retroactively regulating events and costs from 2008 in a fashion that is inconsistent with controlling law and the applicable rate plan.

OCC witness Duann also opines with regard to the 2008 Buyout Agreement that there is a "mismatch of the costs and proceeds regarding the coal contract buyout and negotiation entered by AEP in 2007 and 2008" and that OPCo's customers "should receive all the proceeds from the Settlement Agreement, including the cash payment by [the supplier] and those from the ownership of the [coal reserve]." (OCC Ex. 1 at 7, 12.) Specifically, his recommendations are to immediately credit the fair net present value of the [coal reserve] against the OP FAC under-recovery" and to credit the full $[redacted] million cash payment to OPCo's customers through the FAC during the ESP term. (*Id.* at 7, 12.) The coal reserve is an OPCo asset and ratepayers have no claim on it. (*See* argument below in Section C.6.) But even if such a remedy would be appropriate (which it is not), there is no basis to conclude that Ohio retail customers would get 100% of the cash payments or coal reserve value and there is no reliable evidence in the record of the coal reserve's current value. Moreover, it would also be unfair and punitive to require OPCo to write off the $[redacted] million asset as OCC suggests.

Dr. Duann asserts that a fair and reasonable estimate of the coal reserve is $[redacted] million. (*Id.* at 15.) Under his proposal, once customers receive the $[redacted] million credit, OPCo can create a regulatory asset for the same amount and apply a carrying cost based on OPCo's long-term cost of debt. (*Id.* at 18.) Yet, the true effect of Dr. Duann's regulatory asset proposal is revealed in what he terms a "true-up proceeding." He first admits, in an obvious understatement, that "[i]t is possible that the proceeds from the final disposal of the [coal reserve] will be different from the fair net present value, $[redacted] million, ascertained at the present time." (*Id.* at 21.) He then reveals that, while the true-up can be either positive or negative, any potential shortfall under his proposal "is limited to no more than the difference between the future realized value of the [coal reserve] and $[redacted] million." (*Id.*) Similarly, he admits that if the asset were sold for less that the booked value, OCC's position is that OPCo should absorb the loss. (Tr. II at 215.) In other words, regardless of the outcome of any sale or valuation of the coal reserve, OCC's proposal would require OPCo to write off the asset value properly taken to income in conjunction with the transaction in 2008.

Although Dr. Duann states that he is not proposing any specific option for how and when AEP should develop or dispose of the coal reserve because that decision "is best left for AEP to make" (*Id.* at 14), he promptly proceeds to make several detailed recommendations about how the coal reserve asset should be disposed. In this regard, Dr. Duann recommends the time that carrying charges can be applied should be limited to the earlier of the following three dates: (1) the date the disposal of the coal reserve is finalized and OPCo receives the proceeds, (2) two years from the decision in this case, or (3) January 1, 2013. (*Id.* at 19.) In addition, Dr. Duann indicated his view that "there is definitely a need for a prudence review" of the final disposition of the coal reserve. Dr. Duann prescriptively indicated that the prudence review would be guided in his view by whether OPCo can show that it "can mine the reserve in a cost effective manner and that other outright sale or lease options are not readily available or economically justified." (*Id.* at 20.)

### C. The Companies' position and arguments regarding M/P Audit Recommendation #1 and related Intervenor claims

In his rebuttal testimony, Companies witness Nelson summarized AEP Ohio's position on the intervenor proposals:

> The Audit period of 2009 was clearly established by the ESP order and the RFP that resulted in the hiring of the Auditor for this proceeding. The auditor was to review the appropriateness of the accounting of the FAC costs and the prudency of decisions made. None of the Companies agreements with its coal suppliers were found to be imprudent by the Auditor. The accounting entries related to the settlements addressed in the Audit Report were in accordance with GAAP as discussed by Companies witness Dooley. OPCo and CSP experienced increase fuel costs in 2008 and had a fuel clause been in place in 2008 (which it was not) the Companies deferred fuel balance would have been higher at the end of 2009, not lower. In any case, the Commission should reject OCC's and IEU's improper attempts to clawback and claw forward value that properly remains outside of 2009, the established audit period.

(Cos. Ex. 7 at 4-5.)

The clear intention and desired effect of the OCC/IEU position is to undercut recovery of the fuel deferrals authorized by the Commission as a fundamental component of its decision in the *ESP Cases*. The Commission fully understood that expected (and now materialized) that the projected magnitude of OPCo's fuel deferrals by the end of the ESP was approximately $550 million and the Commission built this factor into the structure of the rate cap/phase-in plan as part of the modified ESP. (*ESP Cases*, Opinion and Order at 20-22.) IEU and OCC have fought vigorously against the fuel deferrals from the beginning and it is no surprise that they attempt to collaterally attack the ESP decision again in this case. See *Ohio Consumers' Counsel v. Pub. Util. Comm.* (Case No.

2009-2022; *Industrial Energy Users – Ohio v. Pub. Util. Comm.* (Case No. 2010-730). But IEU's position and OCC's position are both unlawful and unreasonable and against the manifest weight of the record. Similarly, the Commission understood in deciding the *ESP Cases* that AEP Ohio had no FAC during the pre-ESP rate plans and that there were extraordinary circumstances in the coal market in the period just prior to the beginning of the ESP term. (*ESP Cases*, Entry on Rehearing at 5.) In particular, the Commission adopted a FAC baseline as the one-time transition mechanism to get from unregulated fuel costs to establishment of a FAC starting in 2009. Since those issues were hotly contested and fully decided in the *ESP Cases*, those issues are now *res judicata* and should not be revisited in this proceeding. In any case, the 2008 agreements in question were all prudently entered into and there is no record basis to find otherwise or entertain any disallowance relating to the agreements.

**1. The opportunistic positions of OCC and IEU constitute selective and unlawful retroactive ratemaking.**

In Ohio, there is a constitutional prohibition against the retroactive application of statutes, see Section 28, Article II of the Ohio Constitution, and a statutory presumption in favor of prospective laws, see R.C. 1.48. SB 221 did not become effective until July 31, 2008 – the same date that the Companies filed their ESP application proposing a FAC mechanism starting in 2009. Because AEP Ohio's fuel costs were not regulated during the 2001 through 2008 period and because the ESP's FAC mechanism only became effective in January 2009, the FAC cannot be applied retroactively to encompass recognized transactions occurring in 2008. The same effect would result through any current prudence review of the 2008 contracts for the purpose of disallowing any portion of the ongoing cost impact of those contracts, which were entered into during a period of fuel deregulation when such contracts were not subjected to prudence reviews. Any such effort would violate the terms of the "FAC free" RSP rate plan as well as the new FAC adopted in the *ESP Cases* and would amount to retroactive application of SB 221 in violation of the Ohio Constitution and Ohio Revised Code.

Any such attempt to "clawback" credit amounts booked in 2008 during the prior rate plan (*i.e.*, the RSP period) would also violate the longstanding prohibition against retroactive ratemaking established in *Keco Industries, Inc. v. Cincinnati & Suburban Bell Tel. Co.* (1957), 166 Ohio St. 254. The key principles in the *Keco* decision form Ohio's version of the so-called "filed rate doctrine" and establish the following principles of strictly prospective ratemaking:

- rates set by the Commission are lawful until such time as they are set aside by the Supreme Court and modified on remand by the Commission;
- a utility is entitled to and must collect the rates set by the Commission, unless a stay order is obtained; and
- no action for unjust enrichment lies to recover the rates that were subsequently determined to be unlawful because the comprehensive regulatory scheme in Title 49 abrogates any common law action in this regard.

(*Keco*, 166 Ohio St. at 256-259.) Intervenors in the present case nevertheless ask the Commission to reach back into 2008 during a time that AEP Ohio's fuel costs were unregulated and selectively leverage value obtained during that period for certain contracts in order to offset prudently-incurred costs in the current 2009 audit period.

The Supreme Court's decision in *Lucas Cty. Commrs. v. Pub. Util. Comm.* (1997), 80 Ohio St.3d 344, is part of the *Keco* progeny, *Ohio Consumers' Counsel v. Pub. Util. Comm.*, 121 Ohio St. 3d 362, 367 (Ohio 2009), and is also instructive. The *Lucas County* decision stands for the proposition that, because the Commission may exercise only that jurisdiction conferred by statute and none of the statutes in Title 49 authorizes the Commission to order refunds based on expired programs, the Commission could not order a refund after a pilot program was terminated. Thus, even where the Commission in retrospect disapproves of a utility decision or activity or cost that has already been incurred and collected by the utility pursuant to rates approved by the Commission, the Commission cannot "clawback" any revenue collected under a prior rate.

In addressing an analogous situation, the United States Court of Appeals for the Eighth Circuit Court memorably concluded that the applicable law was like a "fence that is hog tight, horse high, and bull strong" preventing the federal agency from exceeding its regulatory jurisdiction. *Iowa Utilities Board v. FCC*, 120 F.3d 753, 800 ($8^{th}$ Cir. 1997) (reversed in part and affirmed in part). Likewise, the filed rate doctrine under *Keco* and progeny is a bedrock principle of Ohio regulatory law that forms an impenetrable barrier preventing the Commission from engaging in retroactive ratemaking. As discussed below, not only is the OCC/IEU position unlawful, it is selective and one-sided retroactive ratemaking, ignoring other significant fuel expenses and losses incurred in 2008.

**2. Pursuant to the Commission's decision in the *ESP Cases* and the Entry in this Proceeding, the Audit Period is 2009 and the prudence review must be limited to 2009 fuel procurement activities.**

As referenced above, two of the key FAC issues adjudicated and decided in the *ESP Cases* were that: (1) the FAC mechanism would be limited to the ESP period, excluding both the pre-ESP period and the post-ESP period; and (2) annual prudence review of fuel costs would be conducted for fuel costs incurred in 2009, 2010 and 2011.

(*ESP Cases*, Opinion and Order at 14-15.) In adopting the annual financial audit and prudence reviews, the Commission relied upon Staff witness Strom's testimony:

> Additionally, Staff recommended that annual reviews of the prudency and appropriateness of the accounting of FAC costs be conducted (Staff Ex. 8 at 3-4) * * * Therefore, we find that the FAC mechanism with quarterly adjustments as proposed by the Companies, as well as an annual prudency and accounting review recommended by Staff, is reasonable and should be approved and implemented as set forth herein.

(*ESP Cases*, Opinion and Order at 14-15.) In the Staff testimony relied upon by the Commission in adopting the FAC mechanism, Mr. Strom described the annual financial audit and prudence review as follows:

> A review of the appropriateness of the accounting of FAC costs, and the prudence of decisions made relative to the components of the FAC, should be conducted annually. I would expect the audit activities associated with these reviews to begin shortly before the end of each calendar year, and be concluded with an audit report to be filed by early March.

(Staff Ex. 8 at 4.) Thus, there is to be an annual financial audit and prudence review for each of the three years of the ESP relative to fuel procurement activity covered by each audit period and the entire scope of the approved FAC is strictly limited to the three-year term of the ESP. These two key matters involving operation of the FAC mechanism during the ESP were fully adjudicated and decided as part of the Commission's decision in the *ESP Case* – the determinations are *res judicata* and cannot be re-litigated or re-applied on a retroactive basis. *Ohio Consumers' Counsel v. Pub. Util. Comm.* (2006), 111 Ohio St.3d 300, 318 (*res judicata* and collateral estoppel can apply to adjudicative Commission proceedings); *Ohio Consumers' Counsel v. Pub. Util. Comm.* (1985), 16

Ohio St.3d 9, 10 (same). As such, the Commission is precluded from revisiting these issues during the term of the ESP – including in this 2009 FAC Audit proceeding.[1]

Indeed, the Commission has acted thus far in accordance with its decision in the *ESP Cases* in establishing the scope of the audit (it is simply being invited by OCC and IEU to disregard these fundamental limits of the modified ESP's FAC mechanism). As explained in the Commission Entry initiating the RFP to select an auditor in this proceeding:

> The RFP sets forth a three-audit cycle in the Rider FAC audit process. *Audit 1 will be the Rider FAC in place from January 2009 through December 2009*. The scope for Audit 2 will be the Rider FAC in place during January 2010 through December 2010. The scope of Audit 3 will be the Rider FAC in place from January 2011 through December 2011.

(November 18, 2009 Entry at 1 (emphasis added).) This defined scope of audit is consistent with the decision in the *ESP Cases*, as described above, to review fuel procurement activities that occur during each annual audit period that occurs during the ESP term. The current proceeding involves Audit 1, reviewing activities "from January 2009 through December 2009."

The Audit Report issued by EVA also repeatedly acknowledged this limited scope of audit. (*See* Audit Report at 1-1 ("The initial audit covers the January through December 2009 period."), 1-3 ("the initial audit period should include the actual cost for

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[1] By contrast, the Commission may *prospectively* change its prior decisions as a general matter, as along as it reasonably justifies the change. See e.g. *Ohio Consumers' Counsel v. Pub. Util. Comm.* (1984), 10 Ohio St.3d 49, 50-51. And the Commission may entertain what would otherwise be considered a collateral attack in the context of crafting a prospective remedy in a complaint case filed under R.C. 4905.26. *Allnet Comm. Servs., Inc. v. Pub. Util. Comm.* (1987), 32 Ohio St.3d 115, 117. But those types of changes are only permissible if the decisional changes are made prospectively. And there is also an important legal distinction when it comes to changing an approved ESP plan; once an ESP is adopted under R.C. 4928.143 for a specified term, there is no indication that the General Assembly intended to allow the Commission to unilaterally change the ESP during that term. These circumstances are all materially different from the intervenors' position in the instant case advocating retroactive ratemaking.

the Rider FAC for the months January 1, 2009 through December 31, 2009").) Yet, as referenced above, the Audit Report goes on to raise the prospect of violating these aspects of the modified ESP by suggesting the Commission should consider reducing the 2009 under-recovery based on out-of-period activities that were prudent and properly accounted for during 2008.

The Auditor agreed during cross examination that the scope of a FAC audit is generally constrained to reviewing costs incurred during the audit period. (Tr. I at 58.) Ms. Medine also agreed that, audits are normally limited to the audit period because there are discrete periods of review applicable to each audit – the current audit reviews the prior year's activities and the next audit reviews this year's activity, and so on. (*Id.*) Just because there are long-term impacts of prior fuel-related actions of the Companies, that does not mean that the prior rate plan should be abrogated.

The prior rate plan, the RSP (without a FAC), covered 2008 and the current rate plan, the ESP (with a FAC), covers 2009 costs. The Commission adopted the FAC baseline (discussed in greater detail below) to transition from the RSP to the ESP and neither the ESP or RSP decisions should be disturbed. Any fuel procurement decision made by AEP Ohio during the time AEP Ohio's fuel costs were unregulated and were not subject to a prudence review under the regulatory compact applicable at that time. Doing so now in order to address continuing costs or a decision from a prior review period would be akin to disallow a contract that was already subject to prudence review in a prior case.

The Auditor agreed that a long-term coal procurement contract is normally only reviewed once for prudence in an audit. (Tr. I at 85.) Ms. Medine was asked whether, in all of her experience, she has ever observed a regulator going back after a contract passes a prudence review and subsequently making a disallowance associated with the contract based on a new determination that the contract is no longer competitive due to intervening market developments. Her unequivocal response was that "I've *never seen that done* in a regulatory setting." (Tr. I at 87 (emphasis added).) The situation presented in the current case by intervenors' proposal is no less drastic or extreme. The Commission should not reach back into the prior rate plan and review contracts entered into when fuel was unregulated and when there was no prudence review of fuel procurement activity – doing so is the same as revisiting a procurement contract that had already been deemed prudent.

### 3. The FAC baseline was fully litigated and decided in the *ESP Cases* and cannot be modified in this case.

One of the key FAC issues litigated and decided in the *ESP Cases* was to establish the FAC baseline as a one-time determination to put the pre-ESP period fuel costs behind everyone and transition the Companies from a non-FAC period to an active FAC period. Establishment of the FAC baseline was a hotly contested issue that the Commission adjudicated and decided – the FAC baseline is *res judicata* and cannot be re-litigated or re-applied on a retroactive basis. *Ohio Consumers' Counsel v. Pub. Util. Comm.* (2006), 111 Ohio St.3d 300, 318 (*res judicata* and collateral estoppel can apply to adjudicative Commission proceedings); *Ohio Consumers' Counsel v. Pub. Util. Comm.* (1985), 16 Ohio St.3d 9, 10 (same). As such, the Commission is precluded from revisiting these issues during the term of the ESP – including in this 2009 FAC Audit proceeding.

As discussed above, the decision in the *ESP Cases* left no room for re-examination of fuel costs outside the ESP term or limiting recovery of fuel costs within the term based on activity that occurred during the time when AEP Ohio was not operating under a FAC; rather, there was a clear and definitive separation of the ESP period from both the pre-ESP period and the post-ESP period (which makes sense given that the prior rate plan did not have a FAC mechanism and the term of the ESP ended after 2011). The mechanism to transition AEP Ohio from a no-FAC period to an active FAC period was to unbundle the fuel and base generation components of the pre-ESP generation rate to establish FAC and the non-FAC generation rates; the going-in FAC rate level for the ESP was referred to as the "FAC baseline." The FAC baseline was the mechanism to transition from the RSP where no FAC existed to the ESP which did include a FAC.

In litigating the *ESP Cases*, there were widely varying recommendations as to the appropriate FAC baseline:

- Staff's recommended using the 2007 actual fuel costs after adjust them upward by the annual generation rate increases under the RSP of 3% for CSP and 7% for OPCo, in order to calculate a proxy for 2008 fuel costs. *ESP Cases*, Opinion and Order at 19.
- The Companies' recommendation was based on a rate unbundling methodology starting with the 1999 rates and updating them through rate plan adjustments. *Id.*
- OCC recommended using 2008 actual costs and delay the decision if necessary. (*Id.*)

The Commission weighed the evidence carefully and found that "a proxy is appropriate to establish a baseline. Therefore based on the evidence presented, we agree with *Staff's resulting value as the appropriate FAC baseline.*" (*ESP Cases*, Opinion and Order at 19 (emphasis added) (citing Staff's Brief at 3).) In more explicit terms, the Commission specifically adopted Staff's calculation that that 2.625 cents/kWh would be the FAC baseline for CSP and 1.757 cents/kWh would be the FAC baseline for OPCo. (*ESP Cases*, Nelson Rebuttal at 5.)[2]

The primary reason to unbundle AEP Ohio's previously bundled generation rate into FAC and non-FAC components, by (i) determining the FAC baseline and (ii) subtracting it from the generation rate to get the non-FAC rate. But the Staff Brief (at 3), expressly cited and relied upon by the Commission in establishing the FAC baseline (per page 19 of the Opinion and Order), also addressed another reason for establishing a FAC baseline:

> In 2009, the proposed FAC would reflect projected costs. The first step in determining the FAC is to establish a baseline. *This is necessary to ensure that the FAC does not recover fuel costs already being recovered in rates.* The difference between projected costs and the baseline would determine costs to be recovered through the FAC.

(Staff Initial Brief at 3.) Thus, Staff suggested in their position (as expressly adopted by the Commission), that not only would setting the FAC baseline too low render the non-FAC rate too high going into the ESP, but a secondary effect of a baseline set too low would also be that the 2009 FAC rate impact or "bump" experienced by customers would be higher. Conversely, not only would setting the FAC baseline too high render the non-FAC rate too low going into the ESP, but a secondary effect of a baseline set too high would also be that the 2009 FAC rate impact or "bump" experienced by customers would

[2] Because the Commission's ESP Cases relied explicitly on Staff's position regarding the FAC baseline in the *ESP Cases* and since questioning by AEP Ohio's legal counsel of Mr. Hess in this case (who was the lead Staff witness in the *ESP Cases*) was abbreviated with respect to Staff's testimony in the *ESP Cases* about the FAC baseline (Tr. II at 243-244), AEP Ohio requests, to the extent necessary, that the Commission take administrative notice of the ESP testimony in this regard to fully consider that issue in light of intervenors' ongoing attempts in this case to undermine these aspects of the Commission's decision in the *ESP Cases*.

be lower. In addressing their claim that anything other than actual 2008 fuel costs would understate the FAC baseline, OCC witness Smith also raised the same two concerns in her testimony:

> One result is that it will appear that fuel costs are increasing more in 2009 than they actually are, and the FAC adjustment will be larger than if the 2008 actual fuel cost number had been used. Another result will be that the calculated base generation amount will be larger.

(OCC Ex. 10 at 11-12.) The Commission explicitly referenced this testimony in the Opinion and Order (at 19) in the *ESP Cases*.

A third impact of the FAC baseline relates to the interaction of the first two impacts. Namely, the higher FAC baseline advocated by OCC and IEU would have resulted in a lower non-FAC generation rate and created more "head room" when the 2009 projected fuel costs were added to the non-FAC generation rate going into the ESP plan, so that a larger rate increase could have been implemented to achieve the actual rate levels approved in the *ESP Cases*. But the Commission adopted the lower FAC baseline advocated by Staff (which result was similar to the lower FAC baseline advocated by the Companies, though based on a different methodology). In addition to creating a higher non-FAC generation rate, the lower FAC baseline adopted by the Commission resulted in less "head room" for the initial ESP rate increase. When this situation was coupled with the rate caps adopted as part of the modified ESP, it was a sheer certainty that large fuel deferrals would accumulate through implementation of the ESP. The Commission was well aware of the magnitude of 2009 fuel cost deferral/under-recovery anticipated under the rate cap/phase-in plan it adopted, especially for OPCo. (*ESP Cases*, Entry on Rehearing at 5.) Backing away from the fuel deferrals now would violate the regulatory compact and retroactively modify the prior rate plan approved in the *ESP Cases* when the

Commission approved the fuel deferrals for future recovery through a nonbypassable surcharge on all customers in order to mitigate a larger initial rate increase.

IEU understood all three of these related impacts and explicitly raised them on rehearing in the *ESP Cases*, as IEU again advocated for use of 2008 actual fuel costs to establish the FAC baseline:

> Since 2008 actual fuel costs are now known, since they are significantly higher than the "proxy" adopted by the Commission, and since the "proxy" is, by definition, not the prudently incurred costs authorized in Section 4928.143(B)(2)(a), Revised Code, *the Order results in [1] the non-FAC portion of rates being too high and [2] the risk of increases in the FAC portion as well as [3] the amount of deferrals too great.*

(*ESP Cases*, IEU Application for Rehearing at 12.)

Of course, these are the same fuel deferrals being challenged by OCC and IEU on appeal from the *ESP Cases* before the Supreme Court of Ohio. See *Ohio Consumers' Counsel v. Pub. Util. Comm.* (Case No. 2009-2022; *Industrial Energy Users – Ohio v. Pub. Util. Comm.* (Case No. 2010-730.) And it is the same fuel under-recovery that OCC and IEU are again attempting to reduce or eliminate the recovery for OPCo in this proceeding. OCC witness Duann readily acknowledged that OCC has "many issues" with the Commission's decision regarding the FAC in the *ESP Cases*. Some of the ongoing objections of OCC/IEU regarding the original FAC decision include: not using the offset for off system sales, adopting a weighted average carrying cost for deferrals and establishing a FAC baseline that did not use actual 2008 fuel costs. Tr. II at 207-208. Since OCC and IEU have appealed some of those same issues before the Supreme Court of Ohio, they both obviously have an ongoing interest in attacking those issues whenever possible. Their current attempt to collaterally attack the FAC in this proceeding should not be entertained.

Whether the 2009 FAC bump in rates were reduced through adoption of a higher FAC baseline (as was advocated by OCC and IEU in the *ESP Cases*) or through a reduction of the current under-recovery/deferral (as is being advocated by certain intervenors in this case), the effect on OPCo would be the same. In any case, the Commission established the FAC baseline to put the prior no-FAC period behind everyone and transition to the ESP's active FAC mechanism and it violates the decision in the *ESP Cases* to now reach back into 2008 for purposes of adjusting prudently-incurred costs in the current 2009 audit period. Ms. Medine's decision to raise the prior period issues and "bridge" between rate plans does not change the Commission's governing decisions and controlling law. The Commission already created that bridge in the *ESP Cases* when the Commission adopted the FAC baseline. These issues are *res judicata* and collateral estoppel prevents intervenors from re-litigating the same issues in this proceeding.

4. **Each of the 2008 agreements raised by intervenors was prudently adopted and the Commission should not disturb any continuing effects of those agreements, especially given that each agreement was entered into by OPCo prior to commencement of the ESP's new FAC and before the 2009 audit period (*i.e.*, during a period of unregulated fuel cost and when fuel contracts were not subject to prudence reviews).**

The ESP plan was adopted prospectively to cover the 2009-2011 period and transition from the RSP period (where there was no fuel cost regulation) to the ESP period where the FAC mechanism was authorized to permit recovery of all prudently-incurred fuel costs. As such, any ongoing effect of the 2008 agreements in the current 2009 review period cannot be retroactively modified or disallowed in this proceeding.

But even if the Commission contemplates such a disallowance over the legal objections of AEP Ohio, there is no basis in the record to do so.

The Companies supported the prudence of the 2008 transactions through the testimony of Companies witnesses Dooley, Rusk and Nelson. And neither the Auditor nor any intervenor witness even conducted a prudence review of the 2008 agreements, let alone supported the view that any aspect of the agreements was imprudent. On the contrary, the Audit Report categorically concludes regarding the unprecedented coal procurement challenges of the 2007-2008 period (at 1-4) that "AEPSC did an exceptional job during this period particularly with those suppliers that faced financial hardship." Moreover, the Companies submitted unrebutted evidence that the 2008 transactions were properly accounted for per GAAP during a period when fuel costs were unregulated; it would be inappropriate to retroactively implement regulatory accounting as recommended by IEU witness Hess.

The Auditor agreed that the scope of an auditor's task in this type of proceeding is to perform a management/performance audit which includes a prudence component. (Tr. I at 56.) The Auditor also categorically affirmed that in discharging the duty to perform the management/performance audit in this case, including a prudence review, EVA did not reach any findings of imprudence for AEP Ohio. (Tr. I at 58.) For clarity, the Auditor described the substance and process for properly doing a prudence review of a coal contract during cross examination.

The substantive determinations of the prudence review include reviewing: whether the terms were obtained through a competitive procurement and amounted to an arm's length transaction; that the economics of the procurement were superior to alternatives; and that the procurements were consistent with procurement strategy. (Tr. I at 75-76.) She testified that the procedure for reaching those determinations generally include: review of the request for proposal, for the competitive procurement determination; regarding the economics, one should generally focus on a cost analysis and considering non-economic factors as well (counterparty risk, coal quality, delivery issues, and other relevant concerns); and regarding the purchase being consistent with a procurement strategy, an auditor would examine the portfolio strategy design, market exposure and certainty with regard to obtaining the needed supply. (Tr. I at 76.)

The Auditor confirmed that she did not conduct a prudence review with respect to any of the 2008 agreements. (Tr. I at 78-79, 90-91.) And neither OCC nor IEU performed a prudence review. Dr. Duann stated that he did not conduct a prudence review of the agreements discussed in his testimony or even read the agreements. (Tr. II at 201, 206.) And his pre-filed testimony states that he did not opine regarding the prudence of any of the 2008 agreements. (*See also* OCC Ex. 1 at 10.) Moreover, OCC witness Duann agreed on cross examination that he is not an expert in fuel procurement and that his understanding of the contracts is based merely on reading the Audit Report. (Tr. II at 200-201.)

IEU witness Hess also readily acknowledged that he is not an expert in fuel procurement and readily admitted that he did not conduct a prudence review of the 2008 agreements being discussed in this case. (Tr. II at 244.) Thus, there is no basis in the record to conclude that any of the 2008 agreements were imprudently adopted. Accordingly, in addition to being entered into by OPCo outside of the 2009 audit period and during a period of unregulated fuel costs, each of the 2008 agreements raised by intervenors was prudent and the Commission should not disturb any continuing effects of the agreements.

### a) The 2008 Buyout Agreement

The first pre-FAC contract raised by intervenors is the 2008 Buyout Agreement: OCC witness Duann and IEU witness Hess recommend that the Commission reach back into 2008, during the period when AEP Ohio fuel costs were unregulated and fuel contracts were not subject to prudence reviews, and capture the payments and asset transferred to OPCo under this agreement by flowing it back through the now-established FAC. (OCC Ex. 1 at 7, 12.) Regarding the 2008 Buyout Agreement, the Auditor repeatedly testified that EVA did not conduct a prudence review of the settlement (Tr. I at 78, 90, 91), that EVA did not examine the legal claims to determine whether the prior contract was sustainable (Tr. I at 90, 92), and in that context she added that "litigation is always risky." (Tr. I at 90). Another relevant observation that Ms. Medine did make as an OCC witness in the *ESP Cases* concerning the extraordinary 2007-2008 coal market events was that "as difficult as buying coal has been, *what's been even more difficult is contract performance*." (Tr. I at 75.) That is the essence of the circumstances surrounding the 2008 Buyout Agreement. Ms. Medine confirmed that she still agrees with the statement made in her ESP testimony. *Id.* Thus, while the Auditor did not conduct a prudence review, her analysis certainly does not undermine the prudence of the 2008 Buyout Agreement that is otherwise established by the Companies' testimony.

Companies witness Nelson provided testimony regarding AEP Ohio's overall position on this issue:

> At the time the 2008 Settlement Agreement was entered into, there was no FAC and no way to know that the FAC would be reinstated for the Companies in 2009. Also there is no guarantee that the Companies will always have an FAC in the future. Consequently, the Companies maintain that the Commission should limit its review in this proceeding to the audit period. OPCo is comfortable that the review will confirm that it made the proper entries on its books and that payments made or compensation received were treated in accordance with FAC/ESP commencement on January 1, 2009.

(Cos. Ex. 3 at 5.)

Companies witness Rusk testified that the 2008 Buyout Agreement came about because the coal supplier sought payment for change in law claims related to safety expenditures, increases it claimed should be allowed under the existing agreement, and indicated that it may not be able to deliver the existing contractual tonnage due to mining costs in excess of the contractual sale price to OPCo. (Cos. Ex. 2 at 11.) The coal supplier indicated that the contract had been conceived without any expectation of its costs escalating so much and that this had resulted in revenues from the contract being less than their cost to produce. (*Id.* at 11-12.) In response, AEPSC performed an assessment of the claims. (*Id.*) While AEPSC expects its suppliers to honor the terms of their contracts, it also understands that disputes can result in litigation and that the contract in dispute will often not survive the legal process. (*Id.*) As Mr. Rusk testified, it was AEPSC's judgment that, in this instance, the best approach was to attempt to negotiate a resolution to the dispute that would optimize the value associated with the original agreement. (*Id.*)

While it is not possible to know with certainty the results of another course of action, Mr. Rusk testified that in his opinion the contract was not sustainable and the dispute between the coal supplier and AEPSC would likely have resulted in litigation. (*Id.* at 13.) AEPSC extracted a fair value for OPCo in buying out the contract, including

$[redacted] million in payments plus a coal reserve valued at $[redacted] million. (*Id.* at 12.) Mr. Rusk testified that AEPSC did not consider the absence of a FAC in its decision making process on this dispute. (*Id.* at 13.) In his opinion, AEPSC has shown itself to be tough but cooperative; willing to assert its rights but flexible in the face of complex circumstances. (*Id.*) This has been the case during periods with and without a FAC in effect. (*Id.*) The combination of AEPSC's willingness to litigate where suppliers ignore contractual obligations balanced with AEPSC's willingness to renegotiate with troubled suppliers to moderate the loss of contract benefits is a reasonable and prudent overall strategy. (*Id.*)

Regarding GAAP accounting for the 2008 Buyout Agreement, Companies witness Dooley indicated that OPCo received a note receivable from the coal supplier for $[redacted] million with separate payments of $[redacted] million to be made January 15, 2008, July 15, 2008 and January 15, 2009, and also received mineral and real property interests (coal reserves) with an appraised value of $[redacted]. (*Id.* at 3.) To account for the $[redacted] million payment, OPCo recorded a debit to cash (Account 131) for the cash receipt of the first $[redacted] million payment, a debit of $[redacted] million to note receivable (Account 141), and a debit to non-utility property (Account 121) for the coal reserve property estimated value of $[redacted] million. (*Id.*) Subsequently, in July 2008 and January 2009, OPCo received the two separate $[redacted] million payments to reduce the note receivable, recorded as credits to Account 141. (*Id.* at 4. )

Offsetting credits totaling $[redacted] million were recorded as follows: a credit to Other Deferred Credits (Account 253) for $[redacted] million and a credit to fuel expense (Account 501) for $[redacted] million. (*Id.* at 3.) The 2008 credit to fuel expense of $[redacted] million represents the value of the contract settlement not attributable to future coal delivery commitments under the new 2008 contract with the coal supplier. (*Id.*) Thus, it was properly booked as a credit to expense in 2008.

Of the $[redacted] million attributed to future coal delivery, $[redacted] million was estimated as the current portion for 2009 and $[redacted] million was estimated as the long-term portion for 2010. (*Id.* at 4.) The deferred credit balance reflects the net present value of the price differentials for the future coal deliveries of 2009 and 2010 coal commitments when comparing the original contract (terminated under the settlement) and the new 2008 contract.

A portion of the settlement was credited to coal fuel inventory and subject to the FAC. Beginning in 2009 as coal was delivered under the new 2008 contract to OPCo's generating plants, portions of the settlement balance in Account 253, deferred credits, were amortized as credits to Account 151, Fuel Stock (coal inventory). (*Id.* at 4.) Through 2009, $[redacted] million of the previously deferred settlement amount was credited to Account 151. The remaining balance, as of December 31, 2009, of $[redacted] million is expected to be amortized to Account 151 by the end of 2010. Thus, FAC ratepayers will receive $[redacted] million – the amount properly allocated to the 2009-2010 period when OPCo had an active FAC mechanism and the remainder was credited prior to 2009 when OPCo had no FAC.

**b) The 2008 Delivery Shortfall Agreement**

The second pre-FAC contract raised by intervenors is the 2008 Delivery Shortfall Agreement. IEU witness Hess recommends that the Commission reach back into 2008, during the period when AEP Ohio fuel costs were unregulated, and capture the payment made to OPCo under this agreement by flowing it back through the now-established FAC. (IEU Ex. 1 at 9.) Regarding replacing of coal in conjunction with the 2008 Delivery Shortfall Agreement, IEU witness Hess agreed that he had no knowledge about how much spot coal OPCo purchased in 2008 and testified that it was "absolutely correct" that he merely assumed that replacement coal would have been burnt in 2009. (Tr. II at 256-257.) The Auditor testified that the 2008 Delivery Shortfall Agreement was a separate agreement from the 2008 Buyout Agreement. (Tr. I at 94, 96.) She agreed it was fair to presume that the proceeds of the settlement would be used for replacement coal not delivered in 2008. (Tr. I at 96.) And the Auditor confirmed that EVA did not conduct a prudence review of the 2008 Delivery Shortfall Agreement. (Tr. I at 78.) The Companies' testimony establishes prudence and demonstrates that the settlement related exclusively to 2008 – outside the audit period.

Companies witness Nelson provided rebuttal testimony regarding Mr. Hess' recommendation that highlights one of the faulty premises of Mr. Hess' arguments:

> This payment was made to OPCo because the Supplier failed to deliver a significant number of tons of coal in 2008. OPCo was required to go to the market to replace the tons not delivered, since, as has been discussed, the coal market was very tight in 2008 and inventories extremely low. It is my understanding that the cost of replacement spot coal at OPCo plants in 2008 was approximately equal to the liquidated damages. The net effect of these 2008 developments relating to fuel costs was to reduce OPCo's earnings, even after considering those transactions where OPCo received payments in 2008.

(Cos. Ex. 7 at 3.) The transaction was out of period and the overall impact resulted in reduced earnings.

Companies witness Rusk explained in his rebuttal testimony that, while the 2008 Buyout Agreement terminated the prior 20-year supply contract, it provided that the 20-

year supply contract was to continue through the end of 2008. (Cos. Ex. 6 at 2.) However, the supplier failed to deliver about [redacted]% of its required 2008 obligation and AEPSC entered into the 2008 Delivery Shortfall Agreement to resolve that dispute by collecting liquidated damages from the supplier. (*Id.* at 2.) This settlement was entirely separate from the 2008 Buyout Agreement and the settlement amount was calculated by subtracting the contract price from the current market price and multiplying that price delta by the delivery shortfall volume. (*Id.* at 3.) OPCo purchased comparable spot coal in 2008 and its incremental spending was approximately equal to the negotiated liquidated damages payment under the 2008 Delivery Shortfall Agreement. (*Id.*)

Companies witness Dooley also filed rebuttal testimony regarding the 2008 Delivery Shortfall Agreement. (Cos. Ex. 5.) In November 2008, OPCo recorded a debit for $[redacted] to Account 141 (Note Receivable) and credited $[redacted] to Account 501 (Fuel Expense) and $[redacted] to Account 456 (Other Electric Revenues) to record the compensation received related to the coal supplier's failure to deliver the specified tons in 2008. (*Id.* at 2.) Applicable subsequent cash receipts for the note receivable were credited to Account 141. (*Id.*) This accounting was appropriate under GAAP because the compensation received by OPCo in November 2008 related to the shortfall of coal deliveries in 2008 and that otherwise would have been consumed in 2008; thus, the payment was properly recognized to income in 2008. (*Id.*)

In sum, there is no basis for applying the liquidated damages to offset OPCo's current fuel under-recovery as IEU witness Hess recommends. The shortfall deliveries occurred in 2008 as did the note receivable. The 20-year supply agreement was terminated prior to the ESP term and prior to the 2009 Audit Period. (Cos. Ex. 6 at 4.)

The note receivable proceeds was properly accounted for in 2008 as relating to 2008 coal deliveries and OPCo spent an equivalent sum on replacement spot coal during 2008.

### c) The 2008 Contract Support Agreement

The third pre-FAC contract raised by intervenors is the 2008 Contract Support Agreement. IEU witness Hess recommends that the Commission should also "claw forward" to presently quantify *potential* value associated with a 2013 coal purchase option under the 2008 Contract Support Agreement, to further reduce OPCo's current ESP fuel deferrals. (IEU Ex. 1 at 11.) The Auditor confirmed that EVA did not conduct a prudence review of the 2008 Contract Support Agreement, though she reviewed a fair amount of documents and conducted interviews about it. (Tr. I at 79.) The Auditor did confirm that the future discounted price starting in 2013 is an option that OPCo is not obligated to exercise. (Tr. I at 100.) In any case, the Companies' testimony establishes prudence.

Companies witness Nelson provided rebuttal testimony regarding Mr. Hess' recommendation:

> The effect of Mr. Hess's recommendation is to retroactively modify a contract provision in order to reduce CSP's 2009 actually incurred fuel expense. This contract adjustment was not considered imprudent by the Auditor, in fact, as referenced by Company witness Rusk in his rebuttal testimony, the Auditor was complementary of AEPSC's renegotiation of this contract. In this instance, Mr. Hess is not clawing back, but he is attempting to claw forward to capture potential future value and speculatively assume that it applies to the 2009 Audit period. This is as equally problematic as his recommendation regarding the 2008 Settlement Agreement, for the same reasons that were discussed earlier in my testimony.

(Cos. Ex. 7 at 4.) Again, Mr. Hess is recommending an adjustment that not only goes beyond the audit period but beyond the term of the entire FAC mechanism.

Another major problem with Mr. Hess' recommendation is the fact that OPCo is not obligated to purchase coal under this agreement. OPCo merely has a future option starting in 2013 that it may or may not exercise (*e.g.*, it may not need the coal tons) – not to mention that OPCo may not even have a FAC at that future time. As Companies witness Rusk observed in his rebuttal testimony, "[w]hether AEPSC will exercise this option on behalf of OPCo beginning in 2013 and whether OPCo has a FAC in place at that time are both matters that are not presently known." (Cos. Ex. 6 at 6.) Regarding the 2008 Contract Support Agreement, the Auditor also testified that the future discounted price starting in 2013 is an option that OPCo is not obligated to exercise. (Tr. I at 100.)

Further, in response to IEU witness Hess' attempt to reach back and change the agreement through retroactive regulatory accounting, Companies witness Dooley testified that "[t]here is no GAAP basis for deferring the agreed upon price increase for the firm committed tons under this contract to a period beyond" and "[t]here is no firm commitment for the option periods which begin 2013 and thus no basis for deferral." (Cos. Ex. 5 at 2.) In short, there is no record basis from which the Commission could conclude that any of the 2008 agreements were imprudent – which they are not – or to disallow any continuing impacts of the 2008 agreements.

**5. The 2008 Production Bonus Agreement that increased fuel expenses in 2008 is being unfairly ignored by OCC/IEU and intervenors other claims concerning the agreement should be rejected.**

It is not reasonable to, on the one hand reach back to 2008 and bring value forward to the current review period, yet, on the other hand, to ignore the increased costs resulting from other agreements during the pre-FAC time period. Yet, the intervenor testimony does just that. Companies witnesses Dooley, Rusk and Nelson discuss a particular example of this flaw with intervenors' position: the 2008 Production Bonus Agreement. (Cos. Ex. 1 at 4-5; Cos. Ex. 2 at 16-20; and Cos. Ex. 3 at 6.) Neither OCC nor IEU mention the $[redacted] million 2008 Production Bonus Agreement. That is because this countervailing example supports OPCo's position that the Commission should not reach back beyond the audit period and extract value from the other 2008 agreements by reducing OPCo's 2009 FAC under-recovery balance.

Regarding the temporary price adder component of the 2008 Production Bonus Agreement, the Auditor testified that the price paid in 2009 (even including the temporary adder) was market competitive. (Tr. I at 100.) Significantly, the Auditor directly testified that the production bonus portion of the agreement would have been appropriately flowed through the FAC had it occurred under similar circumstances during the audit period. (Tr. I at 102.)

Companies witness Nelson warned against the narrow view OCC/IEU position takes. Specifically, Mr. Nelson stated:

> OPCo made payment during 2008 in the amount of $[redacted] million to another coal supplier, as discussed by Companies witness Rusk. This payment was expensed to account 501 and reduced OPCo's 2008 earnings. OPCo has not sought recovery of this payment since it, like the 2008 Settlement, pre-dated the FAC. Also, other fuel costs increased substantially in 2008. If OPCo had a fuel clause in place in 2008, OPCo would have been protected from the escalation in fuel costs. Accordingly, the Commission should not entertain reaching back into 2008 for a single contract and falsely presume that OPCo had a fuel clause and the ability to make fuel deferrals in 2008.

(Cos. Ex. 3 at 6.) The facts surrounding the 2008 Production Bonus Agreement shows the one-sided and inequitable nature of intervenors' "equity" argument.

In his testimony, Companies witness Rusk explained the background leading up to the 2008 Production Bonus Agreement. In this instance, OPCo assisted a supplier that was in jeopardy of being forced into bankruptcy in 2008, prior to the re-implementation of the FAC. In February 2008, the coal supplier approached AEPSC requesting contract support. (Cos. Ex. 2 at 17.) The coal supplier indicated that it was in jeopardy of breaching certain financial covenants under its loan agreements. The Auditor testified that, based on her experience from a practitioner's point of view, a coal supplier that files bankruptcy has the right to reject coal supply contracts. (Tr. I at 73-74.)

Indeed, the Audit Report on pages 2-23 to 2-24, "concurs that this decision was in the best interest of AEP Ohio ratepayers and commends AEPSC for its efforts." The Audit Report also states as follows (at 1-5) regarding this settlement: "The [redacted] surcharge was a well considered decision in a difficult time. EVA concurs that while expensive, an insolvency of OPCO's largest supplier would have been more expensive." Finally, the Audit Report noted (at 2-23) that throughout most of the period during which the price adder was in place, the market price was in excess of the contract price even including the price adder.

Mr. Rusk added that due to the very high market price of coal as compared to the price being paid under the prior agreement, the coal supplier believed that the lenders were attempting to take the company into bankruptcy, get existing low-priced contracts (including OPCo's) rejected, and take the available tons to the market to sell at much higher prices. (*Id.*) The timing of the coal supplier's potential bankruptcy could not have been much worse. Coal supplies were at very low levels and AEPSC would have been forced to seek replacement coal in a very expensive and volatile market. In fact, based on AEPSC's market knowledge at the time, it would almost certainly have had to execute a multi-year deal just to get coal for the remainder of 2008. (*Id.*)

AEPSC did not accept the coal supplier's claims at face value. As a condition to moving forward with the negotiations, AEPSC gained access to and performed an extensive review of the coal supplier's books, records and debt covenants. This review confirmed the seriousness of the coal supplier's situation. (*Id.* at 17-18.) AEPSC realized that allowing the coal supplier to be forced into bankruptcy would have meant the loss of critical coal supplies at a time when the market was extremely tight and, as a result, trying to obtain alternative supplies at much higher costs for both 2008, and 2009. (*Id.* at 18.) AEP was not the only utility that realized that additional contract support to the coal supplier would be in the utilities' and customers' best interests. The coal supplier represented that it reached similar agreements with other utilities. (*Id.*)

Mr. Rusk testified that AEPSC could not have limited its contract support to only the one-time production bonus, because the coal supplier's creditors would have likely forced the company into bankruptcy, eliminating the opportunity to maintain this valuable supply source during the scarce supply and high price conditions of 2008, and likely would have exacerbated the coal market's difficulties due to the potential loss of some or all of this supplier's annual coal production. (*Id.*) AEPSC would thus have been forced into a position of replacing this supply in 2008 when prices were at $100 - $140 per ton - much above what OPCo paid to this coal supplier for coal in 2009 including the one-year price increase. (*Id.* at 19.) The price for coal in 2010 under this agreement returned to the original contact pricing structure. (*Id.*)

Companies witness Rusk explained that AEPSC could not have secured such a short-term agreement at that time. (*Id.*) At the height of the market shortages in 2008, if companies were selling coal at all, they were insisting on agreements of greater than one year and these were at the then-current extremely high market prices. (*Id.*) Furthermore, a spot agreement in mid-year 2008 would have resulted in very high coal prices into 2009, even without a revised agreement with this coal supplier; OPCo would have likely been forced to buy coal at even higher prices than were paid to this coal supplier possibly extending into or though 2010. (*Id.*)

As Mr. Rusk reported, the coal supplier's parent company announced in [redacted] that it had secured new financing for its operations. (*Id.*) As a result of this development, the coal supplier appears to be on more secure financial footing and to be a viable market participant going forward. Absent the contract support of OPCo and other utilities, this new financing opportunity would not have been possible.

Because there was no FAC in existence in 2008, the cost incurred during 2008 flowed directly through OPCo's fuel expense for that year. OPCo did not attempt to defer recovery of any portion of this 2008 expense into 2009 to be recovered through the FAC. Rather, in 2008, OPCo recorded a $[redacted] million production bonus payment as a fuel consumed expense in Account 501. (*Id.* at 5.) Because this substantial payment occurred in 2008 and related to coal previously delivered and consumed in 2008, it was not reflected in OPCo's FAC. Regarding the $[redacted]/ton ongoing financial assistance under the 2008 Production Bonus Agreement, OPCo charged the cost to Account 151, as coal was delivered. (*Id.*) These payments ceased for deliveries after December 15, 2009. (*Id.*) As Mr. Dooley testified and no other witness contested, the above-described accounting utilized by OPCo conforms to the requirements of GAAP. (*Id.* at 5.)

Another example of pre-FAC fuel cost reductions that have continuing impacts in the 2009 audit period (but which is also selectively screened from intervenors' attempt to reach back into 2008) is the substantial savings achieved by AEPSC in managing its excess volumes starting in 2008. In this regard, the Audit Report's "Major Management Audit Findings" described the 2008 developments brought about by several factors discussed in the Audit Report:

> After spending more than a year focused on acquiring coal, utilities switched their focus to managing the surplus. Utilities did so through some combination of contract deferrals, contract buyouts, higher inventories, remote storage, and forced burn. *AEPSC also did an outstanding job managing its excess volumes.* In part because of the fair treatment it has historically provided its suppliers, *many of AEP's suppliers were willing to defer shipments at no cost.* In addition, AEPSC chose to allow stockpiles to increase rather than pay for reduced shipments *which should benefit ratepayers in the long term.*

(Audit Report at 1-4 through 1-5 (emphasis added).) While these "outstanding" management efforts in 2008 clearly reduced long-term costs – including both 2008 fuel costs and fuel costs in the 2009 audit period – they were not considered by intervenors in their one-sided attempt to challenge select 2008 cost increases. Although not currently quantified, they provide another example of the selective and unfair approach endorsed by OCC/IEU.

**6. The coal reserve property is an OPCo asset for which ratepayers have no claim and its current value is unknown.**

The coal reserve is an asset sitting on OPCo's books and already properly accounted for in 2008 business. This asset was received in conjunction with the 2008 Buyout Agreement and properly accounted for in 2008, as discussed above. OCC witness Duann incorrectly states that the coal reserve "was already paid for by OPC's customers." (OCC Ex. 1 at 20.) And both the OCC and IEU proposals sweepingly presume that the value of the asset must be transferred to customers. This position is flawed and the assumptions regarding the asset's value are speculative.

Customers pay for electricity, not utility assets. Decades ago, the Commission settled the issue of whether ratepayers have an ownership in utility assets when CSP sold its ownership of the Conesville Coal Preparation Plant for a gain in 1988. In that case, the OCC argued that ratepayers should receive a portion of the gain because fuel clause ratepayers had purchased an ownership interest in the assets through their funding of the accumulated depreciation of the equipment. The Commission rejected OCC's argument and found as follows:

> The Commission believes that CSP's EFC ratepayers did not purchase an interest in the ... equipment through the equipment rental component included in the cost of ... coal. *The Commission does not find it appropriate to conclude that the actual nature of the rental component is similar to an installment sale.* The inclusion of an equipment rental component in the cost of coal does not confer the benefits or the risks of ownership of the equipment on those who pay EFC rates which include the cost of coal.

Case No. 88-102-EL-EFC, Opinion and Order (October 28, 1988) (emphasis added). In its December 20, 1988 Entry on Rehearing, the Commission again concluded that it "has no doubt that the ratepayers were not purchasing an ownership interest in the equipment" through the fuel clause rates and the Commission asked the rhetorical question of whether OCC would be before the Commission supporting a rate adjustment to the Company's favor based on this ownership theory had the equipment been sold at a loss.

Of course, Dr. Duann has already answered that question in this case as he explicitly indicated OCC's position is that OPCo alone would absorb any loss associated with the coal reserve. (Tr. II at 215.) In any case, the Commission's holding that customers do not enter into an installment sale for utility assets when they pay rates for service applies here with additional force, given that OPCo customers did not even pay a separate fuel rate for generation service during the pre-ESP period. Ratepayers have no claim on the coal reserve asset. While the Commission need not reach the question of the asset value, it should discount the mistaken reference in the Audit Report and the speculative intervenor testimony regarding the asset value. There simply is no basis in the record to support a present value of the coal reserve asset. As Companies witness Rusk noted in his rebuttal testimony, the initial amount booked for the asset in 2008 was based on an October 2007 report done by an independent contractor and that was the only value known to AEPSC at the time the 2008 Buyout Agreement was entered into and accounted for. (Cos. Ex. 6 at 4-5.)

The higher valuation figure referenced on page 2-21 of the Audit Report was based on a subsequent report done by the same independent contractor in order to assess the developed value of the property. The parameters of the second study included a [redacted] development process, with full production not being reached until [redacted]. (Tr. I at 107-108.) The second study assumed a market price that reached $[redacted] per ton through [redacted]. (Tr. I at 109.) The second study assumed a capital investment of more than [redacted]. (Tr. I at 109-110.) And the second study presumed that the appropriate mine permitting had been secured, which is highly uncertain and takes years to achieve. (Tr. I at 110-111.) Thus, the second study does not establish the current undeveloped value of the coal reserve.

Dr. Duann readily admitted that he was not an expert in real and personal property valuation. (Tr. II at 200.) But he relied heavily on the Audit Report valuation. (Tr. II at 210.) His testimony provides no reliable basis for the current valuation of the coal reserve. The Auditor confirmed that she did not do a valuation of the asset. (Tr. I at 37.)

The Commission should not reach any findings regarding the current valuation of the coal reserve in deciding this case.

**Management Audit Recommendation #2 [Audit Report at 1-7] "The decline in coal demand in 2009 was unprecedented but could be the start of a new era in which coal becomes the swing fuel. AEPSC may need to reconsider new coal procurement strategies to avoid over-commitments in the future."**

AEP Ohio agrees with the auditor, and is currently undertaking such an effort. The advantage of AEPSC's dedicated coal procurement system is its focus on coal procurement and thus its constant review of its processes looking for better ways to secure coal and adapt to changes. As Company Witness Rusk testified, the "current fuel strategy provides for flexibility in on-going decisions that allow it (AEPSC) to adapt to changing market and operational conditions." (Company Ex. 2 at 3.)

AEPSC is set up to be flexible and adjust to changing market conditions. Company Witness Rusk testified to the efforts to maintain that flexibility. AEPSC does not set overly prescriptive long-term and short-term contract percentages and is not constrained by parameters prescribed in a "how-to" manual. (Id. at 4.) He also testified that AEPSC will continue to employ strategic approaches to address market and coal supply circumstances. (Id.)

The Auditor recognized AEPSC's ability to adapt to changes in the market. The Audit Report highlights AEPSC's outstanding job managing its excess volumes. (Audit Report at 1-4.) The Report pointed out the fair treatment AEPSC historically provided its suppliers in part led to those same suppliers to defer shipments at no cost. (Audit Report at 1-5.) The Report also recognizes AEPSC's decision to stockpile coal rather than pay for reduced shipments. (Audit Report at 1-5.)

AEPSC is committed to stay abreast of the options to procure coal in the industry and is open to new coal procurement strategies. It is also an experienced buyer that treats its suppliers fairly and understands the market.

**Management Audit Recommendation #3 [Audit Report at 1-7]**
**"EVA recommends that the next management/performance auditor review the Cardinal 1 scrubber situation and determine what if any FAC costs are due to this situation."**

AEP Ohio is not opposed to a review of the audit period operational issues concerning the Cardinal Unit 1 scrubber in the next fuel adjustment clause proceeding. To be clear that review is properly focused on issues in that audit period. As supported by Company Witness Nelson, "[t]he Audit should focus on whether OPCo was prudent in it actions once the problems were discovered, and whether those responses had any impact on FAC expense. (Company Ex. 3, Nelson Direct at 8-9)

**Management Audit Recommendation #4 [Audit Report at 1-7]**
**"AEPSC should undertake a study to determine whether there is an economic justification for continuing to operate the Conesville Coal Preparation Plant. The study should be completed in time for it to be reviewed in the next management/performance audit."**

AEPSC has already begun an effort to study the continued use of Conesville Preparation Plant and informed the Auditor of these efforts during the audit. (Company Ex. 2, Rusk Direct at 4.) The goal is to formulate a recommendation on the facility this year and, if that is completed, the results will be provided for the next management and performance audit. (Id.)

**Management Audit Recommendation #5 [Audit Report at 1-7]**
**"AEPSC should finalize its update of its policies and procedures manual to reflect current business practices. The update should be completed in time for it to be reviewed in the next management/performance audit."**

AEPSC is currently updating its fuel procurement policies and should have those updates in time for the next management/performance audit. However, it is important to point out that the revisions are focused on procurement polices and not focused on procedures. AEPSC's personnel are very experienced and focused on procurement to achieve the lowest reasonable fuel cost for customers. (Company Ex. 2, Rusk Direct at 5.) Any updates to its policies will ensure the proper flexibility necessary to adapt to dynamic market and operational conditions as supported by Company Witness Rusk. (Id.) The flexibility given to AEPSC personnel allow them to respond in volatile times like the market shift from mid-2007 to the third quarter 2008, where the Auditor stated that "AEPSC did an exceptional job during this period particularly with those suppliers that faced financial hardship." (Audit Report at 1-4) That flexibility will also be necessary to attain Management Audit Recommendation 2 discussed above.

**Management Audit Recommendation #6 [Audit Report at 1-7] "Prior to entering into long-term agreements for renewables with fixed pricing, AEP Ohio should fully evaluate self build and biomass co-firing alternatives and should explore contract options that would provide some protection in the event that the contract pricing for power and/or RECs diverge with market prices for same."**

AEP is constantly exploring the most cost effective sources of renewable generation. As Company Witness Simmons testified, the Company has a New Technology Development Group that conducts an annual renewable planning process, evaluating a wide range of renewable technologies. (Company Ex. 4, Simmons Direct at 4.) Each technology is evaluated on cost, location, feasibility, applicability to AEP's service territory and commercial availability. (Id.) This group also explores the practicality and feasibility of implementing self-build options. (Id.) That analysis includes the availability of site locations suitable for projects, transmission access, available capital and regulatory cost recovery. (Id.)

Bio-mass is one renewable already under consideration. Company Witness Rusk testified that there is a business unit within AEP with responsibility for evaluating biomass co-firing. (Company Ex. 2, Rusk Direct at 6.) He stated that this group would evaluate the purchase of biomass that would be blended with coal to support co-firing in existing plants, if it is shown to be a cost-effective alternative. (Id.)

AEPSC issued two requests for proposals ("RFP") in 2010, one for biomass and another for pre-blended biomass and coal. (Id. at 7.) The fuel sought in the RFP was for the Picway plant, Muskingum River Plant Units 3 and 4, and for the Conesville Plant Unit 3. (*Id.*) The RFP response showed an under-developed market but did identify one supplier that could provide a technically acceptable fuel for Picway and Muskingum at a reasonable cost. (Id.) A purchase order was issued for testing the Picway Plant and Muskingum Plant units. (Id.) After this testing and the corresponding results, AEPSC will be in a better position to seek a new RFP as the market develops.

AEPSC is also considering other co-firing alternatives. It began biodiesel testing at Picway in May 2010 with good technical results. (*Id.* at 10.) This testing involved a blend of biodiesel and fuel acquired from a producer in Ohio. (Id.) There are still questions that need addressed but a biodiesel RFP is under development. Estimates are also being developed to determine the cost of plant modifications needed to use biodiesel. (Id.)

Company Witness Simmons testified that the self-build option recommended by the Auditor is one that is being evaluated by the Company, but is less likely without a clear path to cost recovery. (Tr. Vol. I at 188.) Company Witness Simmons testified that there are a number of different options under S.B. 221 and all of those options should be evaluated. (Company Exhibit 4, Simmons Direct at 6.) However, she testified that any self-build option would need to include a clear path to cost recovery. (Id.) At the hearing Ms. Simmons expanded on that point to explain a concern that there be available a clear ability to deploy capital and guarantee the cost of recovery for all those costs. (Tr. Vol. I at 187.) She further testified that placing a greater emphasis on a self-build option as a mandate could conflict with the Company's goal of focusing on the least-cost option which provides the most benefits to customers. (Id. at 182.)

Ultimately the Company is committed to the consideration of other methods to secure renewable sources of generation. However, that consideration of other options requires analysis of the costs, benefits, and path to recovery of the costs to secure those alternative sources.

## PART TWO: FINANCIAL AUDIT AND RELATED ISSUES

**Financial Audit Recommendation #6 [Audit Report at 1-8]**
**"River Transportation Division ("RTD") should respond to the following prior to the next audit and have the results available for the next auditor to review:**

**a. RTD should be required to explain and justify the rationale of the Net Investment Base and Cost of Capital Billing Adder formula presented In EVA 4-5, Confidential Attachments 1 and 2.**

See response to "e" below.

**b. RTD should be required to provide a procedure for updating the cost of capital and the Return on Equity component that is commensurate with the risk of the operation.**

Company Witness Nelson testified that there is already a procedure in place for updating the cost of capital and Return on Equity (ROE) component commensurate with risk. (Company Ex. 3, Nelson Direct at 11.) He states that the "ROE is adjusted on January 1 each year to the return 'allowed by FERC in a wholesale rate proceeding involving' I&M. In the absence of a recent FERC order the ROE becomes that established by the Indiana Utility Regulatory Commission (IURC) in its most recent order." (Id. at 11-12.) Mr. Nelson makes the point that RTD is a division of I&M, thus using I&M's ROE as determined by the FERC or IURC is commensurate with the risk of operation. (Id. at 12.)

**c. An Over Collection by RTD indicates that RTD collected too much from the affiliated companies for barge operations in a particular year. The Over Collection should be a subtraction from the Investment Base (rather than an addition to RTD's expenses). AEP agrees that a correction is necessary for this.**

Company Witness Dooley testified that RTD has already addressed the issues at the root of the Auditors recommendations in both 6c and 6d. RTD made all the necessary changes to correct the Working Capital Requirement for 2008 and 2009, and will appropriately credit the applicable operating companies, including OPCO, as a result of the changes. (Company Exhibit 1, Dooley Direct at 6.) He also testified that documentation will be available for next year's audit. (Id.)

**d. RTD should provide documentation that it connected its calculation of the 2008 Working Capital Requirement and the 2009 Working Capital Requirement and the resulting credits $43,314 (2008) and $45,117 (2009) to RTD's customers were recorded in its 2nd Quarter 2010 true up and credited to the operating companies in August 2010. OPCO's portion of these credits is $15,298 (2008) and $17,325 (2009).**

See response to "c" above.

**e. Balance Sheet items such as Prepayments, Materials and Supplies Inventory and Other Current and Accrued Liabilities, if considered in developing a utility's rate base, are typically added or subtracted on a 13-month average balance basis. RTD should be required to explain why its current methodology of dividing balance sheet items (such as prepayments, materials and supplies Inventory, and other current and accrued liabilities) by eight to derive the Investment Base is a reasonable and appropriate method.**

The Companies will address recommendations 6a, 6e, 6f and 6j together to be efficient. These recommendations deal with the treatment of balance sheet items and rate elements that differ from traditional treatment. The Companies are willing to have the RTD division amend its calculation to be in accordance with traditional base treatment starting January 1, 2011. Company Witness Nelson testified that the current treatment is a reasonable approach and permitted by the agreement but is not opposed to changing prospectively. (Company Exhibit 3, Nelson Direct at 11.) He further stated, "the balance sheet items will be removed from the 1/8 O&M calculation. Prepayments and Materials & Supplies will be included as13 month averages consistent with the Personal Property (Plant) calculation. Also, a 13 month ADIT balance will be calculated and the investment base ("rate base") will be adjusted accordingly." (Id.)

**f. OPCO, RTD and the other AEP affiliates that utilize the RTD should work together to revise the RTD formula to conform with generally accepted public utility industry rate base and ratemaking standards. OPCO should report quarterly concerning the progress of these efforts by including a description of progress made in its quarterly FAC filings.**

See response to "e" above.

**g. The details of RTD charges including, but not limited to. Other Administration Expenses and "AEP Admin Charges" such as those provided by AEP in response to LA 7-17, should be reviewed in detail in the next audit period.**

The Companies have no objection to this recommendation for items during that audit period.

**h. RTD should prepare a justification for how RTD's income tax expense and Accumulated Deferred Income Taxes are handled.**

Company Witness Dooley testified concerning recommendations 6h and 6i. He stated that "AEPSC will provide explanations as to how RTD's income tax expense and accumulated deferred income taxes are accounted for in preparation for the next audit.

**i. RTD should explain the Accumulated Deferred Income Taxes (ADIT) amounts on its Balance Sheet and identify any amounts and components related to the use of accelerated tax depreciation.**

See response to "h" above.

**j. To the extent that RTD has cost-free capital in the form of ADIT related to the use of accelerated tax depreciation (which would typically be associated with credit-balance ADIT amounts), RTD should prepare an explanation why that cost-free capital should not be subtracted in deriving the Investment Base, similar to how ADIT balances would be subtracted In deriving a utility's rate base."**

See response to "e" above.

# CONCLUSION

The Companies agree with and plan to implement the M/P Audit and Financial Audit Recommendations, as clarified in the Companies' testimony. Regarding M/P Audit Recommendation #1, it is fair to say that the Commission has fulfilled the Auditor's request to consider the equity issue raised. But for a host of legal, policy and factual reasons discussed above, the Commission should reject the OCC/IEU invitation to claw back and claw forward value associated with transactions outside of the 2009 audit period.

Respectfully submitted,

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## CERTIFICATE OF SERVICE

I hereby certify that a copy of the AEP Ohio's Initial Merit Brief was served on the persons stated below via electronic mail, this 23rd day of September 2010.

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