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BEFORE THE
PUBLIC UTILITIES COMMISSION OF OHIO

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

REPLY BRIEF OF COLUMBUS SOUTHERN POWER COMPANY AND OHIO POWER COMPANY

*** PUBLIC VERSION ***

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INTRODUCTION

As AEP Ohio mentioned in its initial brief, the 2007-2008 period involving volatile coal prices reaching all-time historical highs would have been an ideal time to have an active fuel clause mechanism. But AEP Ohio's rate plan at that time did not have an active fuel clause and the Companies were on their own in managing fuel costs during this extraordinary period. AEP Ohio is not complaining because "a deal is a deal" and it agreed to the no-FAC Rate Stabilization Plan (RSP) in effect from 2006-2008. But Intervenors sweepingly ignore this crucial fact and invite the Commission to selectively adjust rates that were charged during this period on a retroactive basis. OCC alone takes the position to a new level by advancing a misguided "netting" theory that AEP Ohio's 2009 fuel costs must *automatically* reflect the unspecified credits to match up perceived out-of-period benefits (on a selective basis) with in-period costs, in order to even be considered actual fuel costs. Setting aside these varying spins used to advance their respective arguments, IEU and OCC both ask the Commission to "claw back" and to "claw forward" to capture transactions beyond the 2009 Audit Period. Their position is flawed in several key respects:

- Intervenors' position constitutes unlawful retroactive ratemaking.
- The Companies accounted for the transactions involved in a manner consistent with Generally Accepted Accounting Principles (the same as they would have done had an FAC been in place), which properly allocated some of the proceeds of the 2008 Buyout Agreement to offset 2008 fuel costs and some of the proceeds to 2009 and 2010 (the latter of which is being flowed through the Fuel Adjustment Clause (FAC) that became effective in 2009).
- Intervenors' position improperly disregards the Commission's action ordering establishment of an Audit Period to govern this case and casts aside well-established regulatory principles for auditing of fuel costs.

- Intervenors' position ignores the fact that AEP Ohio did not have an FAC through the end of 2008, pursuant to the Commission-approved RSP rate plan in effect at that time.

- Intervenors attempt to retroactively change the fact that, under the Commission-approved RSP that was in effect from 2006-2008, AEP Ohio offered a bundled generation rate that not only did not have separate fuel and non-fuel rate components or otherwise track fuel and non-fuel generation costs, but was a market-based rate that the Commission expressly determined would not be tied to costs or earnings.

- Intervenors also attempt to retroactively change the fact that AEP Ohio's fuel procurement decisions and contracts were not subject to a regulatory prudence review when these transactions were entered into.

- Intervenors selectively ignore that AEP Ohio also encountered significant fuel and non-fuel costs during the 2008 period, choosing instead to presume that the bundled generation rate covered those costs.

- Intervenors' position violates the Commission's decision in the *ESP Cases*, by retroactively applying the FAC that was adopted for prospective implementation and violates the hard-fought FAC baseline established by the Commission.

- Intervenors fail to establish any imprudence associated with the transactions, while nonetheless effectively suggesting a disallowance for 2009 fuel costs.

- Intervenors disregard the harmful financial impact on AEP Ohio of fictionally restructuring the involved contracts in order to align selective costs with perceived benefits that occurred in different periods.

With regard to the remedies proposed, while the Intervenors portray them as forward-looking, there is no escaping the fact that the underlying purpose and resulting effect of each proposed remedy is to retroactively modify the rate plan governing 2008. The Intervenors also invoke an inequitable and one-sided position in the name of "equity" and rely on generalized regulatory principles from cases that bear no relationship to this case. Regardless of the subjective motivations relied upon by Intervenors, their requested remedies amount to unlawful retroactive ratemaking and violate the legal principles of *res judicata* and collateral estoppel, since the Commission already decided these matters in adopting the RSP and ESP rate plans (as was fully demonstrated in AEP Ohio's Initial Brief).

AEP Ohio anticipated most of the Intervenors' arguments and already addressed them in its Initial Brief. AEP Ohio continues to advocate each of the arguments made in its Initial Brief and, rather than repeat those applicable and dispositive points again, will merely add a few additional responsive points in this Reply Brief.

ARGUMENT

I. The Commission should *not* rely upon Staff's "belief" statement in deciding this case.

While Intervenors already openly revealed their positions through testimony and through cross-examination and discussion at the hearing, the Staff did not disclose its position or even appear to take a position on these issues through testimony or cross-examination – until filing its brief. Unfortunately, the Staff's entire brief is less than pages in length and contains less than four lines of text at the bottom of page 2 to describe Staff's "belief" regarding offsetting AEP Ohio's 2009 fuel cost, with one additional paragraph on page 3 to suggest an unqualified remedy of punting issues to the next case. Staff's belief statement lacks any explanation or basis, let alone detailed description of what Staff's position means when applied to the complex factual situation at hand. Given the brevity of Staff's initial brief and lack of support for its singular conclusion, the Commission should not rely upon Staff's unsubstantiated in deciding the case. In any case, Staff's endorsement of with the Intervenor position necessarily embraces the same flaws associated with the Intervenor positions, addressed more fully below and in AEP Ohio's Initial Brief.

II. Intervenors' position is unlawful and unreasonable

A. Intervenors' position constitutes unlawful retroactive ratemaking.

IEU and OCC recommend flowing through to future ratepayers the asserted "full benefits" associated with the 2008 Buyout Agreement and the 2008 Delivery Shortfall Agreement because prior rates under the Commission-approved RSP did not fully convey those benefits to ratepayers. Mechanically, IEU claims (at 9-16) that impacts of the 2008 Buyout Agreement and the 2008 Delivery Shortfall Agreement should be modified through after-the-fact regulatory accounting enabling future rate credits that would reflect the full value of the 2008 agreements. OCC similarly advances a "netting" theory (at 5-10) suggesting that "any value such as cash payments or other assets acquired by AEP Ohio as a result of its fuel procurement contracts must be included and properly accounted for in calculating the actual cost of fuel incurred by AEP Ohio." In sum, while the IEU and OCC recommendations differ in detail, they both rest squarely on the fictional notion that the Commission should ignore the actual fuel costs during the audit period and manufacture new fuel costs through netting adjustments that convey perceived benefits previously obtained by AEP Ohio that have not already been conveyed to ratepayers through past rates. Intervenors' position is the essence of unlawful retroactive ratemaking and it is prohibited by Ohio law.

As AEP Ohio discussed in its initial brief, any such attempt to "clawback" credit amounts booked in 2008 during the prior rate plan (*i.e.*, the RSP period) would 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 "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.) Notwithstanding this bedrock principle of Ohio law, 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 audit period.

In support of its bid to capture the value properly booked in 2008 for the Buyout Agreement and Delivery Shortfall Agreement, IEU reviews in detail the history associated with the [redacted] agreement that was terminated at the end of 2008 under the 2008 Buyout Agreement. The gist of IEU's lengthy argument is that the fuel costs that were passed through the fuel clause mechanism in the 1990s were too high in IEU's opinion and, at times, above market rate for coal. Of course, focusing on one fuel supply contract without examining the entire portfolio is a misleading exercise and ignores all of the below-market fuel procurement agreements that AEP reached over the same historical 20-year period and also ignores the price stability achieved by long-term contracts that typically do not remain below market prices at all times during an extended term of years.

In any case, the Commission never disallowed costs under the contract or found the contract to be imprudent.[1] Nonetheless, IEU's basic contention in this regard is that (at 8-9) because there have been times over the 20-year term where the contract price was above market and there was about to be a period during the ESP where the contract price would have been below market, AEP Ohio should not be able to keep the benefits provided when terminating the contract in 2008.[2] In other words, AEP Ohio's future fuel rates should be adjusted to make up for perceived flaws in past fuel rates. As with the netting arguments described above, this IEU theory of making up a shortfall from the past through future rates also defines the very essence of unlawful retroactive ratemaking. The RSP rates charged in the past were authorized by the Commission, were not charged subject to refund or reconciliation, and are conclusively presumed to be just and reasonable. Any rate inequities that occurred during the RSP, whether real or inaccurately perceived, cannot be cured through future rate adjustments.[3]

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1 IEU includes a separate narrative regarding the [redacted] contract as an attachment to its brief. There, IEU acknowledges (Attachment A at 2) that the litigation regarding the prior AEP affiliate that owned this mine resulted in a D.C. Circuit Court decision finding OPCo's fuel costs to be reasonable and lawfully approved by the Federal agencies. So while IEU continues to complain about the prior rates that were based, in part, on the costs incurred by the prior owner of the mine, the fact remains that the Commission never disallowed costs under the contract or found the contract to be imprudent. Even in light of the prior Federal court outcome finding OPCo's rates reasonable and lawful, IEU continues to urge the Commission to employ an unlawful remedy to retroactively cure the past ills perceived by IEU alone. The Commission should decline IEU's misguided invitation.

2 This position ignores the reality that the contract was, in fact, terminated. As AEP Ohio demonstrated in detail as part of its Initial Brief (at 25-31), entering into the 2008 Buyout Agreement was a prudent decision. Because there has been no evidence presented in this case to the contrary, the Commission has no record basis to find otherwise.

3 An Intervenor might argue that, because the FAC rates are always implemented subject to the outcome of the annual audit, the Commission is permitted to make decisions that have retroactive impact on FAC rates. But that argument does not permit

B. Contrary to Intervenors' assertions, there is no basis to conclude that the Companies improperly accounted for the 2008 agreements or attempted to shift costs from a non-FAC period to an FAC period, since the evidence establishes that the Companies' properly accounted for the transactions involved in a manner consistent with Generally Accepted Accounting Principles (GAAP).

IEU's witness Hess, who is an accounting expert well known to the Commission, did not take issue with AEP Ohio's accounting in his testimony or on the stand. Yet, IEU now claims on brief (at 1) that AEP Ohio has "improper accounting practices" and that the Audit "uncovered accounting practices that improperly shift higher costs of renegotiated contracts to customers." Elsewhere, IEU states (at 7) that AEP Ohio's accounting associated with the 2008 Buyout Agreement "is inappropriate." OCC also insinuates (at 13-14) that AEP Ohio intentionally timed the coal supply replacement contract to coincide with the implementation of the new FAC: "Not coincidentally, the new price took effect in January 2009, when AEP Ohio could pass on its fuel cost to customers."

To the extent that IEU's characterizations and OCC's innuendo are intended to suggest that AEP Ohio intentionally shifted costs from a period of no fuel regulation to a period with an active fuel clause, those propositions are manifestly inaccurate and devoid of any record support. The contracts in question were entered into well before SB 221 was even passed (signed into law May 1, 2008), not to mention when AEP Ohio first proposed an FAC mechanism (July 31, 2008) or when the Commission first decided to

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the Commission to do what is being requested by Intervenors in this case: to make adjustments dating back to 2008 and pre-dating establishment of the FAC. The FAC rates can only be reconciled back to the time they were implemented (January 2009) and no further.

approve an FAC for AEP Ohio (March 18, 2009). So it would have literally been impossible for AEP Ohio to knowingly shift costs into the subsequent FAC period at the time it entered into the agreements. If that were not enough, Companies witness Rusk gave unchallenged testimony that AEPSC did not consider the absence of a FAC in its decision-making process on the 2008 Buyout Agreement. (Cos. Ex. 2 at 13.) In addition, the Auditor at page 2-22 states "Further EVA does not mean to suggest any motivation on the part of AEPSC to transfer value from ratepayers in 2009 to 2001 to an earlier date."

Regardless of AEP Ohio's intentions, it is inappropriate for IEU to now claim on brief that AEP Ohio's accounting is improper. On the stand, IEU witness Hess definitively agreed that he was not "making an issue either with the GAAP accounting or the FERC compliance accounting." (Tr. II at 246.) Indeed, Mr. Hess repeatedly acknowledged that a Commission order would have been required to change the accounting in the manner he now advocates. (Tr. II at 247, 250-252.)

More directly, the Companies testimony affirmatively established that all of the 2008 agreements were routinely and appropriately accounted for under GAAP. Specifically, the Companies offered detailed testimony regarding the accounting associated with the transactions at issue and established that the accounting was done according to GAAP. (Cos. Ex. 1 at 3-4.) As explained by AEP Ohio in testimony and on brief, this GAAP accounting treatment was appropriate and properly allocated a portion of the proceeds of the 2008 Buyout Agreement to offset 2008 fuel costs and a portion of the proceeds to 2009 and 2010 (the latter portion is being flowed through the FAC that became effective in 2009). *See* AEP Ohio Initial Brief at 30-31 (discussing Cos. Ex. 1 at 3-4.) The only accounting testimony in the record dealing with these issues was provided by AEP Ohio and none of that testimony was rebutted or otherwise challenged. After-the-fact assertions do not provide record support to challenge AEP Ohio's accounting.

In sum, it is not possible, let alone being supported in the record, for AEP Ohio to have had any intention to shift costs from a non-FAC period to an FAC period. Similarly, there is no basis in the record to conclude that AEP Ohio's accounting practices relating to the transactions inappropriately shifted costs from the RSP period to the ESP/FAC period. On the contrary, the only conclusion supported by the record is that AEP Ohio's accounting for the 2008 agreements was proper and in compliance with GAAP. The reality is that Intervenors do not challenge AEP Ohio's accounting but rather advocate 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 and market-based. As such, it is Intervenors' proposal – not AEP Ohio's actions – that lacks any basis in proper accounting. AEP Ohio properly assigned the 2008 costs and revenues to that period and the rate impacts cannot be retroactively modified without violating both the Filed Rate Doctrine and the Commission's orders adopting AEP Ohio's RSP and ESP rate plans. The Commission has no grounds or record support to retroactively modify AEP Ohio's GAAP accounting relating to the 2008 agreements.

C. While netting costs and benefits might be permissible under certain circumstances involving a single ratemaking period or even across audit periods where there is continuous fuel clause regulation and the decision is made up front, reaching back retroactively to do so in a period where there was no fuel clause and no audit period is inappropriate – especially since doing would also violate multiple aspects of the prior Commission decisions in the *RSP Cases* and the *ESP Cases* governing that prior period.

IEU proposes that (at 11, 15) the "full benefits" of the 2008 Buyout Agreement and the 2008 Delivery Shortfall Agreement be applied to reduce OPCo's fuel under-recovery. IEU also recommends (at 16) that the Companies' accounting for the 2008 Contract Support Agreement be retroactively modified in order to "prefund" potential benefits that may or may not occur in the future. Similarly, OCC argues that AEP Ohio's 2009 fuel costs must automatically reflect an offset for the perceived out-of-period benefits associated with the 2008 agreements, in order to be considered actual fuel costs under various statutes and rules relating to fuel cost recovery and reasonable rates. (OCC Brief at 5-17.) While novel and creative, OCC's misguided reliance on RC 4928.02(A), RC 4928.143(B)(2)(a), OAC 4901:1-35-03(C)(9)(a)(ii) is merely "window dressing" for its underlying effort (which mirrors IEU's goal) to capture perceived out-of-period benefits and net those benefits against the current actual fuel costs. Both OCC's and IEU's recommendations should be rejected, because the precedent relied upon by Intervenors is not instructive, let alone controlling, in this case. Moreover, the remedies Intervernors seek would violate the Commission's decision in the *RSP Cases*.[4]

4 The Commission should also reject the separate netting claims advances IEU (at 15-16) regarding the 2008 Delivery Shortfall Agreement and both by OCC (at 22) and IEU (at 16-17) advance regarding the 2008 Contract Support Agreement, for the reasons already set forth in AEP Ohio's Initial Brief (at 13-35) applicable to all of the 2008

1. The precedent relied upon by Intervenors is not instructive, let alone controlling

As a threshold matter, the cases relied upon by Intervenors to support their netting proposal are inapplicable to this case. Specifically, IEU stated (at 9) that "[t]he Commission's only task is to fairly apply its precedent as well as the regulatory principle that aligns the costs recoverable through rates with the benefits associated with such costs..." In this regard, IEU relies (at 1, note 1) on three unrelated cases to support the assertion that there is a "long-standing regulatory principle that aligns the costs recoverable through rates with the benefits associated with such costs." Similarly, OCC relies on two 1998 cases (at 7, note 15) for the proposition that it was common practice pre-SB 3 to require a utility to include any benefits available as a result of fuel costs, including emission allowance sales and profits from resold coal contracts.[5] OCC also asserts (at 16, note 54) that a basic regulatory principle of matching costs and proceeds was established in a 2006 GCR case involving Piedmont Gas Company.[6]

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agreements and for the additional reasons set forth (at 31-35, 35-40) regarding those two agreements specifically. Similarly, AEP Ohio already fully demonstrated in detail the ways in which Intervenors' position violated the Commission's decision in the *ESP Cases*. AEP Ohio Initial Brief at 16-25..

[5] OCC also relies (at 7) on Rule 4901:1-35-03(C)(9)(a)(ii), Ohio Admin. Code, to suggest that AEP Ohio was required to credit the value from the 2008 contracts against the 2009 fuel costs. This claim is without merit for at least five reasons: (1) the rule was not effective prior to 2009 and cannot be retroactively applied, (2) the rule merely embodies a filing requirement and does not restrict the FAC mechanism that can be proposed or approved, (3) the rule does not supersede or modify the decision in the *ESP Cases* that established AEP Ohio's FAC mechanism, (4) the rule contemplates in-period netting and the out-of-period "benefits" being raised in this case are outside the scope of the rule, and (5) the Financial Auditor, whose job it was to review and verify that AEP Ohio accurately calculated its 2009 fuel costs under the applicable rules, raised no issue suggesting that AEP Ohio did not do so accurately.

[6] OCC cites (at 16, note 54) to an entry in PUCO case number 06-210 as support for its contention that AEP is violating a basic principle of matching costs and proceeds.

In reality, none of the three cases involved netting costs and benefits across different ratemaking periods being advocated here. Moreover, none of the cases involve reaching across audit periods to capture benefits that not only properly relate to that prior period but also relate to a period when there was no cost-based regulation, let alone fuel cost tracking. Further, the cases all involve an up-front decision to match costs and benefits, and none involves an after-the-fact or retrospective decision to alter the costs and benefits or associated accounting. In sum, the cases Intervenors rely upon are inapplicable and do not support their position that the Commission should reach back into a non-FAC period to capture revenue and offset fuel costs prudently incurred in the current FAC period. The same logic applies with additional force to block IEU's attempt to "claw forward" regarding the 2008 Contract Support Agreement – because it not only relates to a future period where an FAC may or may not exist but also attempts to capture value that is uncertain and may not exist.

The cases cited by IEU in its first footnote instead support *AEP's* position that out-of-period actions have no bearing on the in-period review of an audit, especially when the prior period was not under an audited system of fuel adjustment. For example, the Opinion and Order in PUCO Case Nos. 00-220-GA-GCR et al., dealt with the Commission's review of the long term forecast and gas cost recovery proceeding after the sale of Dayton Power and Light's (DP&L's) assets to Vectren. The opinion explains that

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OCC's citation is inaccurate and no such entry exists. PUCO Case 06-210-GA-GCR involves the Northern Industrial Energy Development not Piedmont. A review of the docket shows that the Commission decided to not require an audit of the company in that docket (see 06-210-GA-GCR Entry August 15, 2007). AEP attempted to locate the case OCC intended to cite assuming it was a mistake, but Piedmont's 2006 gas cost recovery case resulted in a stipulation by the parties and no such principle was discussed (see 06-213-GA-GCR Opinion and Order Sept. 13, 2006). In 05-213-GA-GCR the Commission declined to require an audit of Piedmont (see 05-213-GA-GCR, Entry February 1, 2006).

DP&L requested that the audit period be extended to coincide with the sale of DP&L's assets to Vectren. (Case No. *00-220-GA-GCR*, Opinion and Order at 4). The wrapping up of the transactions relating to the sale of the assets was before the Commission for review in the audit period. The Commission determined that GCR customers from the audit period contributed to elements sold by DP&L in the sale of the assets also in the audit period. Therefore, the Commission applied an adjustment in the gas cost recovery proceeding as a result of that audit period. Notably, the "long-standing principle" IEU referenced in its incorporation of *03-219-GA-GCR* is a citation back to the Commission's decision in *00-220-GA-GCR* that was already distinguished above. Predictably, this case suffers from the same fatal flaw distinguishing it from the facts of the pending Commission case- consideration of issues within the audit period, not outside the period. In this case, the Commission considered profits accrued during the audit period from a relationship between the utility and the parks system for taking gas and returning the same amount at a later date. Again, this was a transaction during the audit period adjusted in the appropriate follow-up as outlined in the Commission's gas cost recovery system.

The 1984 case cited by IEU is also inapposite because it deals with the statutory formula to produce a rate in a rate case. In the portion of the *84-414-EL-AIR* decision IEU cites, the Commission is accounting for the operating revenues and expenses of the utility from the test year. It is not appropriate to compare the Commission's guidance on an early discussion of the uncertainty of off-system sales and how that relates to operating revenues and expenses in a rate case to out-of-audit-period adjustments in the inaugural period of a fuel adjustment clause.

The EFC examples used by OCC in footnote 15 (PUCO Orders in cases 98-103-EL-EFC and 98-102-EL-EFC) also fail to support its contention in this case to include out of period actions in an audit period. The Orders are mid-year findings pointing out that emission allowance auction proceeds are included as part of the proposed adjustment. In both cases the Commission points out that the entire year will be subject to a full review in the company's annual EFC hearing in the docket. (98-103-EL-EFC at Para. 5.) OCC is mixing apples and oranges here. Under the EFC cases there was an ongoing review of the utility's fuel clause with adjustments made mid-year and annual proceedings as well. That is not the circumstance in this case. Again, this is the inaugural fuel clause and attempts to compare cases from a long-term fuel clause that considered ongoing issues from year to year are inappropriate.

Finally in this regard, OCC also includes a citation to the Supreme Court of Ohio's *Elyria Foundry Company et al., v. Pub. Util Comm.*,114 Ohio St.3d 305, 314, 2007 Ohio 4164, 871 N.E.2d 1176 in footnote 56 (page 17). OCC treats the Court's description of the utility's stipulation being appealed to the Court as the Court's "instructions" in the case. In actuality the Court reversed that provision in paragraph 58 of the opinion. OCC cannot rely upon the overturned stipulation provision as authority for its position.

In sum, the comparison between the cases relied upon by Intervenors and the instant case and the corollary attempt to establish precedent or authority for IEU's proposed remedy do not hold.

2. Intervenors' position on brief violates additional aspects of the Commission's decision in the *RSP Cases*, even beyond the ways already anticipated and addressed in AEP Ohio's Initial Brief.

As described in AEP Ohio's Initial Brief, the Companies established a Rate Stabilization Plan (RSP) that was in effect from 2006 through 2008, under which there was no fuel adjustment clause or comparable mechanism. (Case No. 04-169-EL-UNC, January 26, 2005 Opinion and Order; March 23, 2005 Entry on Rehearing) There were also capped "discretionary" increases under the RSP but they did not encompass fuel cost changes and have no relevance here. Thus, there was no guarantee that the RSP's generation rates would cover the Companies' fuel costs and the Companies were "on their own" with respect to recovery of fuel costs during the RSP period of 2006 through 2008. 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 at the time of the 2008 agreements and through the end of 2008.

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 the upside results achieved by AEP Ohio under its prior rate plan, while leaving AEP Ohio to absorb the downside results. This would have violated the RSP rate plan had it occurred during the 2006-2008 term and would be doubly inappropriate to entertain on a retroactive basis years after the RSP has expired.

At the Commission's urging, AEP Ohio proposed the RSP based on a stable source of revenue and the Companies had to manage its generation costs (both fuel and non-fuel) around that revenue stream associated with the bundled generation rates. Intervenors now argue that the Commission should be concerned with matching/netting the fuel costs and benefits across the RSP and ESP terms, based in part on the premise that ratepayers have not fully realized certain benefits associated with select fuel procurement transactions occurring in 2008. In anticipation of some of IEU's and OCC's arguments, AEP Ohio's already fully addressed some of the major ways that Intervenors' position violates the Commission's decision in the *RSP Cases*, including that it is inappropriate to reach back into the RSP term and selectively capture perceived benefits because: (1) the Companies' fuel costs were not regulated during the RSP term, (2) the Companies' fuel procurement activities were not subject to prudence review during the RSP term, and (3) the Companies were at risk for recovering their fuel costs through pre-established generation rates. AEP Ohio steadfastly maintains the ongoing validity of those arguments. But reviewing Intervenors' briefs has revealed additional ways that their position violates and undermines the Commission's decision in the *RSP Cases*.

Contrary to the suggestion of Intervenors on brief, ratepayers already received the benefits of the 2008 transactions: preordained, stabilized generation rates during a period of volatile and increasing generation costs. Those are the same benefits the RSP provided for both fuel costs and non-fuel generation costs alike and without regard to earnings. This key structural component of the RSP was reflected through the bundling of fuel and non-fuel rates and the establishment of fixed, pre-established annual increases. In other words, base generation rates under the RSP were charged without the creation of separate fuel and non-fuel rate components and without regard to earnings.

The Commission's decision in the *RSP Cases* made these points very clear, emphasizing that the bundled generation rate was to be market-based and was not based on costs or earnings of the Companies:

> *[P]arties seem to forget that*, with the expiration of the [market development period], *generation rates are subject to the market (not the Commission's traditional cost-of-service rate regulation) and* that the plan was an option that AEP voluntarily proposed. Section 4928.05(A)(1), Revised Code. We make this observation to point out that, *under the statutory scheme, company earnings levels would not come into play for establishing generation rates – market tolerances would otherwise dictate, just as AEP argued.* We are strongly committed to encouraging the competitive market in AEP's service territories, as it is the policy of this state, per Section 4928.02, Revised Code. Given that commitment, *we do not feel that the earnings levels evidence or cost-based analyses* and *arguments presented by OEG, OCC, IEU-Ohio or LIA justify rejection of this provision* [the fixed increases of bundled generation rates under the RSP]. *We believe that this provision will establish generation rates that are appropriate for the RSP period, spur the competitive market, and also protect customers from dramatic or volatile rate price changes.*

RSP Cases, January 26, 2005 Opinion and Order at 18 (emphasis added; internal citations omitted). In other words, ratepayers received stabilized generation rates during the RSP term and avoided paying higher market rates, while helping foster development of the competitive market for generation service – all without regard to cost or earnings. On rehearing, the Commission again emphasized that "company earnings levels do not come into play *for establishing its generation rates* under the statutory framework for competitive electric generation service and, thus, that earnings evidence did not convince us that we should reject the proposed fixed generation rate increases." *RSP Cases*, March

23, 2005 Entry on Rehearing at 6 (emphasis original). The Commission should again remind OCC and IEU of what they seem to have forgotten: the RSP rates were market-based rates not tied to cost or earnings. The Commission unequivocally rejected the idea of evaluating the fixed generation rate increases based on cost or earnings at the time it adopted the RSP and it would be doubly inappropriate to entertain this same theory now on a retroactive basis, years after the RSP expired.

The above-quoted passage from the *RSP Cases* sets forth the key reasons why the Commission adopted the RSP and the primary feature of the RSP was the fixed increases of the bundled generation rate. Elsewhere in its decision, the Commission again reiterated that the pre-established generation rate increases under the RSP would create two valuable benefits for customers:

> With the RSP's structured, periodic generation rate increases, customers will not be subjected to significant swings in generation rates in an emerging competitive market for AEP. *We believe this provision [the fixed increases for bundled generation rate] is not only very important to spurring a competitive market, but also to protecting customers from the risks and dangers associated with price volatility and a nascent competitive market.*

RSP Cases, January 26, 2005 Opinion and Order at 18 (emphasis added). In other words, ratepayers received stabilized generation rates during the RSP term and avoided paying higher market rates, while helping foster development of the competitive market for generation service. Hence, both of the primary benefits upon which the Commission based its adoption of the RSP – rate stability and the development of competitive market through increased generation rates that better reflect market prices – have been fully realized by customers. It would violate the prior rate plan to presently reach back to extract additional benefit based on a highly selective review of certain fuel costs from

2008. This important feature of the Commission's decision in the *RSP Cases* is unreasonably ignored and would be retroactively obliterated by the positions advanced by Intervenors in this case.

In a manner directly inconsistent with the decision in the *RSP Cases*, the Intervenor position falsely presumes that a fuel cost reduction or offset in 2008 directly translates into an earnings opportunity for the Companies or a savings that must be paired up with future fuel costs and netted out. In reality, any given fuel cost reductions in 2008 simply created additional headroom under which to manage non-fuel generation costs under a bundled generation rate. Because the RSP provided that base generation rates were to compensate the Companies without the creation of separate fuel and non-fuel rate components and, more importantly, without regard to earnings or costs of the Companies, it is inappropriate to review one without the other (even aside from being inappropriate as a general matter to retroactively review any aspect of the RSP).

As Companies witness Nelson testified in the instant case, fuel cost increases were, in fact, the principal driver behind OPCo's return on equity declining from 12.4% in 2007 to 9.4% in 2008. Ultimately, however, the issue of whether a fuel cost reduction during the RSP is offset by a higher implied non-fuel component of the generation rate has no meaning under the RSP decision since the rates were not adjusted based on cost or earnings. In any case, the Commission cannot possibly reach any conclusions about the propriety of fuel costs or margins during the RSP period without also examining the non-fuel costs or margins for the same period. Those matters are beyond the scope of the evidentiary record in these proceedings and, in any case, are improper to examine *ex post facto* in light of the RSP's distant expiration. The Commission should reject Intervenors' unreasonable and unlawful attempts to modify the Commission's decision in the *RSP Cases* after the adopted rate plan has been fully implemented and has expired.

D. Intervenors fail to establish any imprudence associated with the transactions, while nonetheless effectively suggesting a disallowance for 2009 fuel costs.

The primary question in this FAC case is whether AEP Ohio prudently incurred its fuel costs during the Audit Period. Intervenors do not claim, let alone establish, that it was imprudent to enter into any of the 2008 agreements at issue in this case. Of course, it would be fundamentally unfair and would violate the Companies' due process rights if any such claims were raised for the first time in a reply brief. In any case, AEP Ohio fully addressed and established the prudence of each of the 2008 agreements through testimony and extensive and detailed, record-based arguments on brief. *See* AEP Ohio Brief at 25-35. That evidentiary showing addressed in detail the 2008 Buyout Agreement (at 28-31); the 2008 Delivery Shortfall Agreement (at 31-34); the 2008 Contract Support Agreement (at 34-35); and the 2008 Production Bonus Agreement (at 35-40). AEP Ohio's arguments regarding prudence went un-rebutted by Staff and Intervenors in testimony and on brief, yielding the uncontested conclusion that AEP Ohio's decisions regarding the 2008 agreements were prudent. Without a finding that AEP Ohio failed to properly account for and prudently incur its 2009 fuel costs, there is no basis for the Commission to disallow any of those costs.

III. To the extent the Commission entertains Intervenors' claims (over AEP Ohio's objection and challenge), there are additional aspects of Intervenors' proposed remedies that disregard the harmful financial impact on AEP Ohio, are unfair and on-sided and are otherwise unreasonable.

Intervenors get ahead of themselves by spending a large portion of their briefs discussing various remedies when they have not established that there is a legitimate problem to be remedied. AEP Ohio has demonstrated that there are significant legal barriers to the Commission entertaining any of the proposed remedies and that there is otherwise no justification to adopt any of those remedies. Nonetheless, AEP Ohio will briefly address some of the remedies being advanced by Intervenors. While Intervenors repeatedly invoke "inequities" (OCC at 14) and "equity" (IEU at 5, 9), the real impact of their position is to "cherry pick" perceived out-of-period benefits and disregard the prior RSP and current ESP rate plans. As such, the advocated remedies are unreasonable, in addition to being unlawful.

The largest inequity with Intervenors' position is that they selectively ignore that AEP Ohio also encountered significant fuel and non-fuel costs during the 2008 period, choosing to presume that the bundled generation rate covered those costs. It is not reasonable to, on the one hand reach back to 2008 and bring value forward to the current review period, and yet, on the other hand, ignore the increased costs resulting from other agreements during the pre-FAC time period. Nonetheless, Intervenors seek to do 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. 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.) 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. Most 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.)

Another example of inappropriate remedies advocated by Intervenors is IEU's suggestion that the Commission "re-price" the coal purchased from [redacted] at a market-based price during 2009 by fictionally assuming that AEP Ohio paid the price from the terminated contract, claiming (at 15) that this remedy is "a cleaner way" to resolve the disagreements in this case and (at 14) that it fosters "administrative convenience." This approach amounts to a disallowance of fuel costs actually incurred in 2009. Under the decision in the *ESP Cases* adopting the FAC mechanism, AEP Ohio is to recover all fuel costs prudently incurred during the audit period and, absent a finding that 2009 fuel costs were not prudently incurred, there is no basis for the Commission to disallow any of those costs. Notably, no Intervenor has independently challenged the prudence of the replacement coal purchase agreement with [redacted] that actually does involve 2009 fuel costs, as it was a market-competitive price. The only evidence regarding the prudence of the replacement coal agreement affecting 2009 fuel costs is the Companies' testimony establishing prudence and there is no record basis to "re-price" the market-competitive 2009 fuel costs.

All the Parties seem to agree that the present "as is" value of the coal reserve asset is unknown. *See* OCC Brief at 19, 20 (before the Commission can credit AEP Ohio's customers a reasonable net present value of the coal reserve must be established, the Commission must first seek to determine a fair value of the coal reserve before it can properly credit the FAC deferral balance); IEU Brief at 13 (while it may be tempting to pick a value for the coal reserve, the evidence of record shows a wide range of valuations and "the Commission should postpone its judgment on the final valuation"); and AEP Ohio Brief at 40-43 (there are no qualified expert witnesses in this case that have evaluated the current "as is" value of the coal reserve).

While Intervenors build on their flawed position by asking for an advance on the coal reserve asset valuation, there is no basis in the record to conclude the current "as is" value of the coal reserve asset. Nonetheless, IEU asks for a provisional credit of $[redacted] million for the coal reserve, pending further valuation, claiming (at 13-14) that such a credit would not harm OPCo's cash flow because it would be used to reduce the fuel under-recovery. Similarly, OCC requests a credit to reduce OPCo's fuel under-recovery, claiming (at 21-22) that it would not "adversely affect the cash flow and the financial health of AEP Ohio, and the proposal will serve the financial health of Ohio consumers who otherwise will be asked by AEP Ohio to pay the deferrals." OCC and IEU are wrong.

Crediting the under-recovery in this manner would harm OPCo's future rates, future cash flow, and OPCo' income and equity. If ordered to reduce the deferral, OPCo would take a loss (it would not be able write up the value of the asset). A loss reduces the regulatory asset, net income and equity and results in reduced future cash flow (and rates would be reduced eventually). It would have immediate negative effects on earnings and the balance sheet and in the long-run would rob OPCo of its cash reimbursement for the value of the fuel provided.

In sum, the Commission should not rely upon any of the valuation figures in the record as a basis for deciding this case, because none of them reflect the present "as is" valuation of the coal reserve. For the same reasons stated in AEP Ohio's Initial Brief and in this Reply Brief demonstrating that the Commission should not consider clawing back or clawing forward to capture perceived value that is properly accounted for outside the 2009 Audit Period, the Commission should not inflict harm on AEP Ohio by ordering a provisional credit based on the unknown value of the coal reserve.

CONCLUSION

The Commission should reject the Staff/Intervenor positions that invite the Commission to engage in unlawful retroactive ratemaking and abrogate the RSP and ESP decisions.

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CERTIFICATE OF SERVICE

I hereby certify that a copy of the AEP Ohio's Reply Brief was served on the persons stated below via electronic mail, this 15th day of October 2010.

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