

**FILE**

**BEFORE  
THE PUBLIC UTILITIES COMMISSION OF OHIO**

In the Matter of the Commission Review )  
of the Capacity Charges of Ohio Power ) Case No. 10-2929-EL-UNC  
Company and Columbus Southern Power )  
Company. )

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**INDUSTRIAL ENERGY USERS-OHIO'S  
MEMORANDUM CONTRA APPLICATION FOR REHEARING**

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On December 8, 2010, the Public Utilities Commission of Ohio ("Commission") issued an Entry in this proceeding ("December 8 Entry") finding that:

Prior to the filing of this application, the Commission approved retail rates for the Companies, including recovery of capacity costs through provider-of-last-resort charges to certain retail shopping customers, based upon the continuation of the current capacity charges established by the three-year capacity auction conducted by PJM, Inc., under the current fixed resource requirement (FRR) mechanism.<sup>1</sup>

The December 8 Entry also initiated a review to consider proposed changes to Ohio Power Company's ("OP") and Columbus Southern Power Company's ("CSP") (collectively "AEP-Ohio" or "Companies") capacity charges and invited comments from interested parties as part of this review. More specifically, the December 8 Entry requested input on: (1) what changes to the current state mechanism are appropriate to determine AEP-Ohio's fixed resource requirement ("FRR") capacity charges to Ohio competitive retail electric service ("CRES") suppliers; (2) the degree to which AEP-Ohio's capacity charges are currently being recovered through retail rates

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<sup>1</sup> December 8 Entry at 1-2.

approved by the Commission or other capacity charges; and (3) the impact of AEP-Ohio's capacity charges upon CRES suppliers and retail competition in Ohio.

On January 7, 2010, AEP-Ohio filed an application for rehearing ("Application") contesting the December 8 Entry proactively issued in this proceeding by the Public Utilities Commission of Ohio ("Commission"). As explained below, the Application is without merit based on the law and, among other things, the evidence in Case Nos. 08-917-EL-SSO and 08-918-EL-SSO.<sup>2</sup>

## **I. THE AUTHORIZED REVENUE AND COST RECOVERY SHELL GAME**

AEP-Ohio's Application resorts to a theme that AEP-Ohio has used in Commission proceedings since Ohio moved away from cost-based ratemaking. Since its authorized revenue is no longer tied to accounting costs that AEP-Ohio has recorded on its financial books, it has become fond of claiming that a particular category of costs was not explicitly considered or addressed by the Commission and therefore is not being covered by the revenue that AEP-Ohio is authorized to bill and collect from customers. In effect, AEP-Ohio is using its authorized total revenue collection as a shell and then asserting that the shell includes no compensation for a particular category of costs unless the revenue can be explicitly and specifically traced back to a particular cost component.

Since Ohio's ratemaking process produces rates (and revenue) that are not specifically based on or tied to costs, Ohio's ratemaking process provides a convenient

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<sup>2</sup> *In the Matter of the Application of Columbus Southern Power Company for Approval of its Electric Security Plan; an Amendment to its Corporate Separation Plan; and the Sale or Transfer of Certain Generating Assets*, Case Nos. 08-917-EL-SSO, *et al.*, Application (July 31, 2008) (hereinafter "*the ESP Proceedings*").

opportunity for AEP-Ohio to flip the switch between costs and revenue when it suits its purpose.

AEP-Ohio's revenue/cost shell game is designed to allow it to escape accountability even when a pea appears when the shell is lifted. Should anybody be able to point to a game winning pea when the shell is lifted, AEP-Ohio then proceeds to argue that the revealed pea is not the right pea that must be discovered to win this challenging game of chance.

In this particular case and as discussed below, IEU-Ohio believes that the Commission specifically considered PJM Interconnection, LLC ("PJM") capacity costs in the determinations that resulted in the revenue that AEP-Ohio is authorized to collect. In other words, the right pea can be identified under the AEP-Ohio revenue shell. But, IEU-Ohio also urges the Commission to, nonetheless, reject AEP-Ohio's effort to frame the question as though explicit Commission recognition for a particular category of cost is necessary before the Commission can block AEP-Ohio's efforts to secure more than just and reasonable compensation by changing labels and moving the shell game to a Federal Energy Regulatory Commission ("FERC") venue where shell games are nurtured and protected.

If the revenue which AEP-Ohio is authorized to collect in the aggregate is covering all the costs (including a reasonable return), a claimed lack of compensation for one category of costs is nothing more than an implicit admission of excessive compensation for some other cost category. IEU-Ohio urges the Commission to reject AEP-Ohio's invitation to turn regulation into a game of chance that gives consumers no odds for getting to a just and reasonable result.

## **II. DUE PROCESS**

At page 21 of the Application, AEP-Ohio advances the argument that the December 8 Entry deprives it of due process (notice and a hearing) because the Commission has unilaterally established or changed a rate. AEP-Ohio is essentially accusing the Commission of misconduct because the Commission used its authority to frustrate AEP-Ohio's effort to secure FERC approval to unilaterally establish or charge a rate in ways that would blindside customers and CRES suppliers.

AEP-Ohio provided no notice to interested parties that it filed an application at FERC to double-recover capacity charges and impose an undue prejudice on CRES suppliers. AEP-Ohio advocacy at FERC continues to push FERC towards unilaterally approving a change to rates without holding a hearing. If AEP-Ohio is seriously interested in making sure that the letter and spirit of the principle of due process are respected, it can agree (in the FERC proceeding it initiated) **not** to impose its proposed new capacity pricing mechanism until there is adequate notice and a hearing on all contested issues of fact and law.

In any event, AEP-Ohio is not entitled to notice and due process before it is blocked from ignoring compliance with a Commission order. The Commission has not altered AEP-Ohio's revenue collection opportunity and has not established or altered any rates or charges. If anything, the Commission's December 8 Entry merely confirms what the Commission previously determined.

### III. THE COMMISSION'S JURISDICTION

AEP-Ohio's Application (beginning at page 18) asserts that the Commission is without jurisdiction to establish a mechanism addressing capacity cost recovery. It argues that this is a subject within FERC's exclusive jurisdiction. This claim is without merit.

As discussed below, AEP-Ohio proposed a provider-of-last-resort or POLR charge and the Commission disposed of the proposal as a **distribution charge**. AEP-Ohio has not claimed in its Application that the Commission lacked jurisdiction to consider and act on the POLR proposal. However, the logic in AEP-Ohio's attack on the Commission's actions to confirm that the POLR compensation includes PJM capacity costs suggests that the Commission had no jurisdiction to establish the POLR charge in the first place. Indeed, the logic of AEP-Ohio's jurisdictional arguments suggests that the Commission lacks authority to permit an electric distribution utility ("EDU") to recover charges that have been established pursuant to authority delegated to FERC by Congress.

In other words, the basic legal theory AEP-Ohio has advanced in its Application is fundamentally defective without regard to any of the facts or circumstances in this case. And, as such facts and circumstances are considered, AEP-Ohio's alleged errors and arguments distance themselves further from any form of logic (good or bad) that provides any reason to grant the Application.

On November 1, 2010, American Electric Power Service Corporation ("AEP"), on behalf of CSP and OP, filed an application ("FERC Application") in FERC Docket No. ER11-1995. On November 24, 2010, AEP re-filed its FERC Application at the direction

of FERC, in FERC Docket No. ER11-2183-000. The FERC Application proposes to unilaterally change, effective January 1, 2011, the basis for establishing prices that drive compensation for capacity by adopting formula rate templates and accounting data which AEP-Ohio proposes to use to periodically calculate new prices for capacity. In its FERC Application, AEP asserted that its proposal to change the basis for establishing prices for capacity is consistent with Section D.8 of Schedule 8.1 of the PJM Reliability Assurance Agreement ("RAA") . Section D.8 of the RAA provides, in relevant part:

**In a state regulatory jurisdiction that has implemented retail choice, the FRR Entity must include in its FRR Capacity Plan all load, including expected load growth, in the FRR Service Area, notwithstanding the loss of any such load to or among alternative retail LSEs. In the case of load reflected in the FRR Capacity Plan that switches to an alternative retail LSE, where the state regulatory jurisdiction requires switching customers or the LSE to compensate the FRR Entity for its FRR capacity obligations, such state compensation mechanism will prevail. In the absence of a state compensation mechanism, the applicable alternative retail LSE shall compensate the FRR Entity at the capacity price in the unconstrained portions of the PJM Region, as determined in accordance with Attachment DD to the PJM Tariff, provided that the FRR Entity may, at any time, make a filing with FERC under Sections 205 of the Federal Power Act proposing to change the basis for compensation to a method based on the FRR Entity's cost or such other basis shown to be just and reasonable, and a retail LSE may at any time exercise its rights under Section 206 of the FPA.<sup>3</sup>**

The above-quoted language has been approved by FERC. The FERC-approved language makes it clear that state compensation mechanisms prevail on issues related to compensation for capacity in cases where retail load reflected in an FRR capacity plan switches to a CRES and the state acts to establish a compensation mechanism. In the absence of a state compensation mechanism, the above-quoted language provides

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<sup>3</sup> Reliability Assurance Agreement Among Load Serving Entities in the PJM Region, Schedule 8.1, § D.8 ("Fixed Resource Requirement Alternative") (emphasis added).



for a default compensation mechanism; the CRES is to compensate AEP-Ohio based on PJM's capacity price in the unconstrained region as determined by Attachment DD to PJM's FERC-approved tariff. Only in the absence of a state compensation mechanism does the FERC-approved language permit AEP-Ohio (or AEP acting on behalf of AEP-Ohio) to make a Section 205 filing under the Federal Power Act ("FPA") for the purpose of changing the basis of compensation.

In its FERC Application, AEP alleged that Ohio had not established a compensation mechanism for capacity sales<sup>4</sup> knowing (or at least implicitly acknowledging) that it could not file a Section 205 filing if Ohio had established such a mechanism.

Based on the facts and applicable law, the Commission's determination (in the December 8 Entry) that it "...approved retail rates for the Companies, including recovery of capacity costs through provider of last resort charges to certain retail shopping customers..." has controlling significance based on the FERC-approved language in PJM's RAA. The Commission's December 8 Entry is not exercising jurisdiction over any subject that is within the exclusive jurisdiction of FERC. It has only made a determination that has significance and is controlling under the FERC-approved RAA on the question of how and when AEP-Ohio is free to propose a change in the basis for compensation.

As IEU-Ohio has stated previously, if AEP-Ohio wishes to challenge the requirements of PJM's RAA as they apply here, it is free to do so by filing a complaint at FERC. But it is not free to dishonor the requirements of the FERC-approved language

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<sup>4</sup> FERC Application, Transmittal Letter at 3.

in the RAA while proceeding with a Section 205 filing that is made available in the RAA only when such requirements have been satisfied.

At page 21 of its Application, AEP-Ohio states that “[w]hen the General Assembly wants to empower the Commission to perform acts delegated to it under federal law, it must confer statutory jurisdiction to do so – as it has done in order to implement the 1996 Telecommunications Act through enactment of Section 4927.04, Revised Code.” It then asserts that the General Assembly has not chosen to do so in the case of electricity. The Commission has previously rejected the argument that a specific grant of authority is required before it can make a determination that has significance for purposes of implementing a requirement approved by FERC.

In the ESP Proceedings, AEP-Ohio asked the Commission to approve a provision that would block retail customers from participating in PJM’s demand response programs. One of the parties in the ESP Proceedings argued that 18 C.F.R. Section 35.28(g) prohibited the Commission from granting AEP-Ohio’s request, based on the following text:

Each Commission-approved independent system operator and regional transmission organization must permit a qualified aggregator of retail customers to bid demand response on behalf of retail customers directly into the Commission-approved independent system operator’s or regional transmission organization’s organized markets, unless the laws and regulations of the relevant electric retail regulatory authority expressly do not permit a retail customer to participate.

The party advancing this claim asserted that the General Assembly had not delegated specific authority to the Commission to determine whether or not retail customers are permitted to participate in demand response programs and that the Commission had no

authority to prohibit such participation. The Commission rejected the claim, responding as follows:

The Commission finds that the General Assembly has vested the Commission with broad authority to address the rate, charges, and service issues of Ohio's public utilities as evidenced in Title 49 of the Revised Code. Accordingly, we consider this Commission the entity to which FERC was referring in the Final Rule when it referred to the 'relevant electric retail regulatory authority.' We are not convinced ... that a specific act of the General Assembly is necessary to grant the Commission the authority to determine whether or not Ohio's retail customers are permitted to participate in the RTO's demand response programs.<sup>5</sup>

While IEU-Ohio believes, as explained above, that the December 8 Entry does not operate to exercise federal jurisdiction, the General Assembly has delegated jurisdiction to the Commission to determine whether an electric utility has violated or failed to comply with any provisions of Sections 4928.01 to 4928.10, Revised Code, or any rule or order adopted or issued thereunder.<sup>6</sup> Section 4928.05(A)(2), Revised Code, requires the Commission to exercise its jurisdiction with respect to the delivery of electricity "... so as to ensure that no aspect of the delivery of electricity by the utility to consumers in this state that consists of a noncompetitive retail electric service is unregulated." The General Assembly has also directed the Commission to use its delegated authority to secure the consumer and other benefits identified in Section 4928.02, Revised Code.

Where an EDU such as OP or CSP files an application with FERC that is precluded by language approved by FERC and the application seeks to secure an undue competitive advantage by imposing a redundant, noncomparable and

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<sup>5</sup> *ESP Proceedings*, Opinion and Order at 57-58 (March 18, 2009) (hereinafter referred to as "*March 18 Order*").

<sup>6</sup> Section 4928.15(A)(2), Revised Code.

discriminatory charge on CRES suppliers, the Commission has plenty of authority to do the right thing and an affirmative duty to do so.

#### **IV. THE SIGNIFICANCE OF THE FRR ELECTION**

AEP-Ohio's Application revisits the evidence in the ESP Proceedings and claims (at pages 6 and 9) that "[t]he POLR charges relate to an entirely different service and are based on an entirely different set of costs than the capacity charges provided for in Sch. 8.1, Sec. D.8 of the RAA." At page 7, AEP-Ohio claims that "[t]he Commission erroneously asserts in Finding 4 of its Entry that in the *ESP Cases* , it approved retail rates, 'including recovery of capacity costs through provider-of-last-resort (POLR) charges to certain retail shopping customers, based upon the continuation of the current capacity charges established by the three-year capacity auction conducted by PJM, Inc., under the current fixed resource requirement (FRR) mechanism'". At page 9 of the Application, AEP-Ohio states: "Simply put, the PUCO's approval of retail POLR charges do [sic] not compensate CSP and OPC for the wholesale capacity that they are required to make available as FRR Entities under the RAA". At page 11 of the Application, AEP-Ohio claims that "... the Companies' POLR charges were never intended to compensate CSP and OPC for meeting their wholesale FRR capacity obligations ...".

AEP-Ohio's claims are stunningly false.

Attachment B to AEP-Ohio's Application contains the direct testimony of J. Craig Baker, an AEP-Ohio witness in the ESP Proceedings ("Baker Testimony"). The Baker Testimony touches on many topics including the development of a market-price to

benchmark the results of the ESP, the proposed POLR charge, the means of developing a POLR charge, and the input variables used by AEP-Ohio to quantify the POLR charge. (The Baker Testimony is discussed in more detail below.)

Section 4928.12(A), Revised Code, requires each EDU to participate in a regional transmission organization ("RTO") and AEP-Ohio currently participates in the PJM RTO. Under PJM rules, all suppliers with load serving responsibilities (including AEP-Ohio) must maintain adequate capacity resources to reliably meet their customers' needs.<sup>7</sup>

AEP-Ohio elected to meet PJM's capacity requirements through the FRR option under the reliability pricing model ("RPM"), which is PJM's capacity market.<sup>8</sup> AEP-Ohio elected the FRR option for five years, which is the minimum term allowed by the RAA and PJM's Tariff.<sup>9</sup>

All of AEP-Ohio's available generating capacity located in the PJM RTO is bid into the PJM energy market. In other words, the entire generating capacity of AEP-Ohio is offered to PJM and it is up to PJM to determine what to do in response to these offers.<sup>10</sup> On any given day, the actual load presented by AEP-Ohio customers could, in accordance with PJM's determinations, be served by generators other than those owned or operated by AEP-Ohio.<sup>11</sup> Regardless of who actually owns the generation

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<sup>7</sup> Tr. Vol. XI at 60-61. Unless otherwise noted, all transcript citations are citations to the transcript for the ESP Proceedings.

<sup>8</sup> Tr. Vol. IX at 52; Tr. Vol. XI at 61. PJM's capacity market is designed to ensure there is enough actual generation capacity to reliably serve all PJM customers' needs.

<sup>9</sup> Tr. Vol. XI at 61.

<sup>10</sup> *Id.* at 56-57, 65.

<sup>11</sup> *Id.* at 57-58.

capacity, PJM dispatches available generation capacity to serve load and maintain real-time reliability.<sup>12</sup> Moreover, even if AEP-Ohio did not own any generation at all, PJM would still dispatch generation in order to meet the needs of AEP-Ohio's customers.<sup>13</sup>

By electing the FRR option for five years, AEP-Ohio committed to being the sole load-serving entity for retail load for AEP-Ohio customers **for purposes of meeting the resource adequacy requirements specified by PJM**. Thus, AEP-Ohio committed to being responsible for meeting the reserve requirements even for retail customers that elect to take service from a competitive supplier as if that customer remained a retail customer of AEP-Ohio.<sup>14</sup>

Under the FRR option elected by AEP-Ohio, a CRES supplier serving a retail customer has no capacity obligation in PJM's market model unless that CRES supplier opted to self-supply capacity within the time permitted under PJM's rules. If retail customers of AEP-Ohio are providing AEP-Ohio with adequate compensation to cover the cost of the capacity obligation AEP-Ohio elected when it opted for the FRR option, then any proposal by AEP-Ohio to collect PJM capacity costs from a CRES supplier serving a retail customer in AEP-Ohio's service area is, by definition, a proposal to collect excessive revenue.

Additionally, AEP-Ohio receives benefits associated with its FRR election as opposed to participating in PJM's RPM auction process. For example, Staff Witness Johnson indicated that there is a significantly large cost advantage as a result of the

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<sup>12</sup> *Id.* at 59-60.

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* at 60-61.

difference between RPM and FRR.<sup>15</sup> Further, AEP-Ohio has the opportunity to sell and has sold generating capacity into the RPM market.<sup>16</sup> Once AEP-Ohio has met PJM's reserve requirements and if AEP-Ohio has capacity in excess of that amount, it may sell the next 1,300 megawatts into the RPM market.<sup>17</sup> When AEP-Ohio has a capacity surplus within this bandwidth, it has sold the excess capacity into the market for a profit.<sup>18</sup> In approving the POLR charge, the Commission did not net any of the benefits AEP-Ohio derives from the FRR election against the POLR revenue collectable from AEP-Ohio's retail customers.

The citations to the record in the ESP Proceedings provided herein show that the FRR option, its role in the PJM capacity market, and AEP-Ohio's obligation under the FRR option to satisfy the capacity obligation for shopping and non-shopping customers were discussed and explained during the evidentiary phase of the ESP Proceedings. From the record in the ESP Proceedings, the Commission knew that the POLR charge was not based on any accounting costs. The Commission knew that the POLR charge would generate hundreds of millions of dollars in revenue regardless of whether customers shopped or did not shop. The Commission knew that AEP-Ohio elected the FRR option with the understanding that by doing so it would thereby have the exclusive load-serving entity obligation to satisfy PJM's capacity obligation regardless of whether retail customers shopped or did not shop.

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<sup>15</sup> Tr. Vol. XII at 186-187.

<sup>16</sup> Tr. Vol. XI at 63-64.

<sup>17</sup> *Id.* at 63-65.

<sup>18</sup> *Id.* at 64.

## V. WHAT'S IN THE POLR BLACK BOX

So now we return to AEP-Ohio's witness J. Craig Baker and his testimony on what went into his computation of the revenue collectable by AEP-Ohio from the POLR charge.

As mentioned above, the Baker Testimony included a computation of the market price of full requirements generation service which AEP-Ohio urged the Commission to use for purpose of benchmarking the ESP against the Market Rate Offer ("MRO") alternative. The tables showing the derivation of the benchmark price are on page 13 of the Baker Testimony.

At lines 2 through 6 of page 13, the Baker Testimony states (emphasis added): "As can be observed from the tables, the most significant contributors to the overall cost of full requirements service are the direct energy cost, **the capacity obligation implemented by PJM**, and the load shaping and following premium necessary to convert the standard quoted energy product to the specific load profiles of CSP and OPCO." At page 14, the Baker Testimony states (emphasis added): "The second largest factor is the **PJM capacity component**, which accounted for approximately 14% and 12% for CSP and OPCO respectively, of the total price"; and "**The PJM Capacity Obligations** were calculated using the published results of PJM capacity auctions."

A discussion regarding the POLR charge begins at page 25 of the Baker Testimony. Page 26 of the Baker Testimony states that the flexibility provided by AEP-Ohio as a default supplier of generation supply imposes costs on AEP-Ohio. "There is a definite and significant cost associated with providing this flexibility. In addition to the challenges of **providing capacity** and energy on short notice, the



Companies would provide service to returning customers at the SSO rate (even though they are likely to be returning because market prices exceed the SSO)." Also at page 26, the Baker Testimony acknowledges the role of the POLR in facilitating opportunities for CRES suppliers by asserting that the AEP-Ohio POLR charge proposal "... advances the policy outlined in Section 4928.02(A), Ohio Rev. Code, to promote diversity of electricity supplies while also advancing the policy to maintain reasonably priced retail electric service."

Beginning at page 29, the Baker Testimony explains how AEP-Ohio quantified the revenue that it proposed to recover through the POLR charge. An identification of the quantitative inputs used to arrive at the POLR revenue amounts begins at page 31 of the Baker Testimony and is shown in table form on page 31. The Baker Testimony shows that the POLR revenue computation starts with **"[t]he competitive benchmark prices discussed in relation to the MRO"**.<sup>19</sup> As explained above via the Baker Testimony, the competitive benchmark price includes a component for PJM capacity and the PJM capacity component is the second largest component of all the components included in the quantification of the benchmark price.

Mr. Baker also testified during cross-examination by the Industrial Energy Users-Ohio ("IEU-Ohio") that the prevailing auction prices for capacity under PJM's RPM were used as a proxy for the capacity compensation component built into the POLR charge because there was no explicit price for capacity under the FRR option selected by AEP-Ohio:

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<sup>19</sup> Tr. Vol. XIV at 245.

Q. Mr. Baker, page 11, lines 13 and 14, one of the inputs that you used for purposes of pricing the POLR is the PJM Reliability Pricing Model, the Capacity Auctions. I assume there you're talking about the RPM.

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A. The section we're looking at was to come up with a benchmark price. This section was for the JCB-2, but it is the price that we then carried over into the calculation of POLR.

Q. Right. You're using -- for purposes of developing the input value for this component, you're using PJM's RPM, correct?

A. That's correct.

Q. You're not using a value for FRR.

A. That is correct, because there is not a -- we don't have a value for FRR. And what we're trying to do is look at what the competitive price would be, and the competitive supplier is likely to be an RPM participant given the fact that we're the only FRR -- major FRR entity at this time.<sup>20</sup>

If the Baker Testimony left any doubt about how AEP-Ohio calculated the revenue for the capacity component of the POLR, Mr. Baker's answers to cross-examination questions left none.

What does all of this mean?

It means that AEP-Ohio has been selective about the POLR revenue component for which it wants a do over. AEP-Ohio's FERC Application is only focused on the capacity component. It wants to drive its capacity-related revenue collection opportunity upward by using some poorly explained and unsupported formula rate that it claims is cost-based. For the larger POLR energy component identified in the Baker Testimony, AEP-Ohio wants to compute the revenue collection opportunity based on a market-based approach. The lack of symmetry in AEP-Ohio's FERC Application proposal

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<sup>20</sup> Tr. Vol. XI at 76-77.

highlights the extent to which AEP-Ohio is engaged in a strategic effort to unreasonably and unlawfully protect itself from the market forces that have finally begun to provide consumers a break.

It means that regardless of what service one may claim to be provided to customers in exchange for the POLR charge, **the POLR revenue includes compensation for capacity because that is the way AEP-Ohio developed the POLR charge which was (almost entirely) approved by the Commission.**

It means that AEP-Ohio is demonstrably wrong and misleading when it claims (at pages 6 and 9 of the Application) that "[t]he POLR charges relate to an entirely different service and are based on an entirely different set of costs than the capacity charges provided for in Sch. 8.1, Sec. D.8 of the RAA."

It means that AEP-Ohio is demonstrably wrong when it claims (at page 7 of the Application) that "[t]he Commission erroneously asserts in Finding 4 of its Entry that in the *ESP* Cases, it approved retail rates, 'including recovery of capacity costs through provider-of-last-resort (POLR) charges to certain retail shopping customers, based upon the continuation of the current capacity charges established by the three-year capacity auction conducted by PJM, Inc., under the current fixed resource requirement (FRR) mechanism'".

It means that AEP-Ohio is demonstrably wrong when it claims (at page 9 of the Application) that: "Simply put, the PUCO's approval of retail POLR charges do [sic] not compensate CSP and OPC for the wholesale capacity that they are required to make available as FRR Entities under the RAA".

It means that AEP-Ohio is demonstrably wrong when it claims (at page 11 of the Application) that "... the Companies' POLR charges were never intended to compensate CSP and OPC for meeting their wholesale FRR capacity obligations ...".

#### **VI. AEP-OHIO IS ALREADY COLLECTING EXCESSIVE REVENUE RELATIVE TO TOTAL COSTS**

A number of the parties submitting comments, including IEU-Ohio, have pointed out that AEP-Ohio's ESP-enabled opportunity to collect revenue for capacity-related costs is not limited to the POLR charge. For example, IEU-Ohio (and other parties) explained that both OP and CSP have in place Environmental Investment Carrying Cost Riders ("EICCR"). These riders allow OP and CSP to recover carrying costs that "are necessary to recover the ongoing cost of investments in environmental facilities and equipment that are essential to keep the generation units operating."<sup>21</sup> Clearly, such charges are designed to compensate AEP-Ohio for capacity related costs rather than energy related costs.

As importantly, the incremental ESP revenues being collected by AEP-Ohio are on top of revenue that was historically available to OP and CSP through cost-based ratemaking and the revenue authorizations of the Commission. These legacy rates have been escalated over the years by rate stabilization plans ("RSP") and, more recently, the ESP Proceedings. The ratemaking methodology that produced these legacy rates computed OP's and CSP's revenue requirement by including the value of generating assets providing capacity as well as energy.

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<sup>21</sup> March 18 Order at 24-28.

For example, OP has long had much more generating capacity than it needs to meet the needs of its retail customers.<sup>22</sup> In traditional rate cases, this condition prompted claims that OP had "excess capacity" or more generating capacity than was necessary to reliably meet the needs of its Ohio customers.<sup>23</sup> Historically speaking, parties advanced an excess capacity claim as a predicate for recommending adjustments to the valuation of the "used and useful" property or "rate base" to remove the "excess" amount of the generating plant from the jurisdictional cost of service established by the traditional ratemaking formula.<sup>24</sup>

But, the Commission's traditional regulation precedent on excess capacity involved a two-part test. First, the Commission addressed the question of whether the actual generating capacity was physically excessive. If the answer to this question was positive, the Commission then conducted an economic analysis to determine if the excessive physical capacity was also excessive from an economic perspective. Only if the generating capacity was excessive from both a physical and economic perspective did the Commission then proceed to consider a cost of service reduction because of excessive capacity.<sup>25</sup>

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<sup>22</sup> OP was and "... is part of the highly-integrated AEP power pool that is operated and planned as a single system." *In the Matter of the Application of Ohio Power Company for Authority to Amend its Filed Tariffs to Increase the Rates and Charges for Electric Service and Related Matters*, Case Nos. 94-996-EL-AIR, *et al.*, Opinion and Order at 45 (March 23, 1995) (hereinafter cited as "OP's 1995 Case").

<sup>23</sup> *In Re Application of Ohio Power Company*, Case No. 85-726-EL-AIR (July 10, 1986) at \*133-134; 76 P.U.R. 4<sup>th</sup> 121 (hereinafter cited as "OP's 1986 Case").

<sup>24</sup> *Id.*

<sup>25</sup> In *In the Matter of the Application of The Cleveland Electric Illuminating Company to Increase Certain of its Filed Schedules Fixing Rates and Charges for Electric Service*, Case No. 78-677-EL-AIR, Opinion and Order at 8 (May 2, 1979), the Commission reviewed a Staff recommendation that no rate base adjustment be made despite finding that an electric utility had 15.06% more capacity than indicated by the Commission's twenty percent (20%) reserve margin benchmark for evaluating electric utilities' capacity in accordance with Section 4905.70, Revised Code (repealed as part of Ohio's electric restructuring legislation):

In OP's historical circumstance, this two-part excess capacity test resulted in the Commission rejecting proposed negative adjustments to the rate base valuation. While the Commission agreed that OP had excessive generating capacity from a physical perspective, it rejected a ratemaking adjustment because OP's ability to "... sell its excess capacity at profitable rates benefits its customers. These rates provide a means of reducing the jurisdictional revenue requirements that would otherwise be borne by the company's jurisdictional customers."<sup>26</sup>

So, at least from a historical perspective, OP's Ohio customers have carried responsibility (in their rates and charges) for the capacity-related costs of OP's generating assets which would have otherwise been excessive but for the reduction in the jurisdictional revenue requirements made possible by the contribution from non-jurisdictional sales. It appears that this balance of costs and benefits is reflected, to a

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In deciding whether such an adjustment is appropriate, a number of vital considerations must be borne in mind. First, it is axiomatic that an electric utility is expected to construct and maintain capacity which is sufficient to provide reliable and adequate service to its customers on an ongoing basis, allowing for long term load growth, fluctuations in usage patterns, unscheduled outages, and a variety of other complex factors which impinge upon its ability to meet its load. Second, given the long lead time required for major power plant construction and the uncertainties inherent in long term load forecasting, it is totally unrealistic to expect that even the most prudent utility will have the precise amount of capacity it needs at a given point in time. Finally, given the fact that capacity must be added in fairly large increments, a utility's reserve margin can normally be expected to fluctuate from year to year. The relevant question, therefore, is not whether the Applicant's reserve margin exceeds the optimum level, but whether it exceeds that level by an amount which is unreasonable in light of the foregoing factors, or which indicates that the Company acted imprudently in its capacity planning.

See also *In the Matter of the Application of the Dayton Power & Light Company for Authority to Modify and Increase its Rates for Electric Service to All Jurisdictional Customers*, Case No. 76-823-EL-AIR, Opinion and Order at 6-7 (July 22, 1977).

<sup>26</sup> OP's 1986 Case at 133.

currently unknown extent, in OP's present retail rates.<sup>27</sup> The same is undoubtedly true in the case of CSP.

The structure of the electric industry has changed significantly since the back-in-the-day debates over excess capacity and value of generating assets that should rightly be attributable to Ohio retail customers. Today, there are many more opportunities for OP and CSP to deploy their generating assets into the various markets operated by PJM to gain revenue and net income and they are taking advantage of these opportunities.

As explained above, OP and CSP currently participate in PJM. All of their available generating capacity is bid into the PJM market. In other words, AEP, acting on behalf of each of its operating companies, offers the output of available generating units to PJM. It is up to PJM to determine what to do in response to these offers.<sup>28</sup> Regardless of who actually owns the generation capacity, PJM will dispatch available generation capacity to serve load and maintain real-time reliability.<sup>29</sup> Under the PJM rules, all suppliers with load serving responsibilities (including OP and CSP) must maintain adequate resources to reliably meet their customers' needs.<sup>30</sup>

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<sup>27</sup> OP's most recent traditional rate case was resolved by the Commission's adoption of a settlement. *OP's 1995 Case*. Based on the content of the settlement, it is not possible to observe the rate base valuation that was used to form the signatory parties' recommendation that OP receive a revenue increase of \$66,000,000. It is clear that the Commission did not address any excess capacity claim in OP's most recent traditional rate case.

<sup>28</sup> Tr. Vol. XI at 56-57, 65.

<sup>29</sup> Tr. Vol. XI at 59-60.

<sup>30</sup> Tr. Vol. XI at 60-61. PJM's resource adequacy requirements and generating resource dispatch responsibilities also have significance relative to the Companies' claims regarding the risks they face because of their default supplier obligations.

While the subject of off-system sales has been a frequent topic in recent Commission proceedings, less attention has been paid to the other opportunities that OP and CSP have had to secure benefits from the markets established by PJM. For example, the Companies have opportunities to generate revenue from their generating assets in PJM's capacity market and energy market.<sup>31</sup> And, the Companies have obtained revenue from these markets.<sup>32</sup> The Companies also have opportunities to sell into PJM's ancillary services market.<sup>33</sup>

If CRES suppliers serving retail customers in AEP-Ohio's service area are, via AEP-Ohio's FERC application, going to be made responsible for capacity costs, AEP-Ohio will receive a windfall. It is for this reason that IEU-Ohio has recommended that all of the capacity-related revenue that is collectable by CSP's and OP's legacy rates (as such rates have been escalated over time) must be credited against the capacity invoice that AEP-Ohio proposes to send to CRES suppliers.

Circumstantially, there are other indications that the rates of CSP and OP provide too much total compensation regardless of how "just and reasonable" are defined.

For example, the gross revenue margin (revenue less fuel and purchased power expense)<sup>34</sup> per MWH of the OP and CSP<sup>35</sup> (as shown by the evidence in the ESP Proceedings) suggests that the customers of OP and CSP have been carrying their

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<sup>31</sup> Tr. Vol. XI at 63.

<sup>32</sup> Tr. Vol. XI at 64.

<sup>33</sup> Tr. Vol. XI at 66-68.

<sup>34</sup> Tr. Vol. IV at 285. The "East Integrated Utilities" line includes Appalachian Power Company, Kentucky Power Company, I&M [Indiana Michigan Power], Wheeling Power and Kingsport Power Company. Tr. Vol. IV at 287.

<sup>35</sup> The term "Ohio Companies" refers to CSP and OP. Tr. Vol. IX at 112.



weight (and perhaps more) when it comes to fairly compensating OP and CSP. As shown at page 11 of IEU-Ohio Exhibit 2,<sup>36</sup> the gross margin per MWH reported for AEP-Ohio for the third quarter of 2008 was \$43.9 per MWH compared to \$46.8 per MWH for the corresponding quarter in 2007. In both quarters, the next highest gross margin per MWH contribution to earnings per share by any American Electric Power ("AEP") business unit came from Off System Sales (at between \$32 and \$33 per MWH).



## Quarterly Performance Comparison

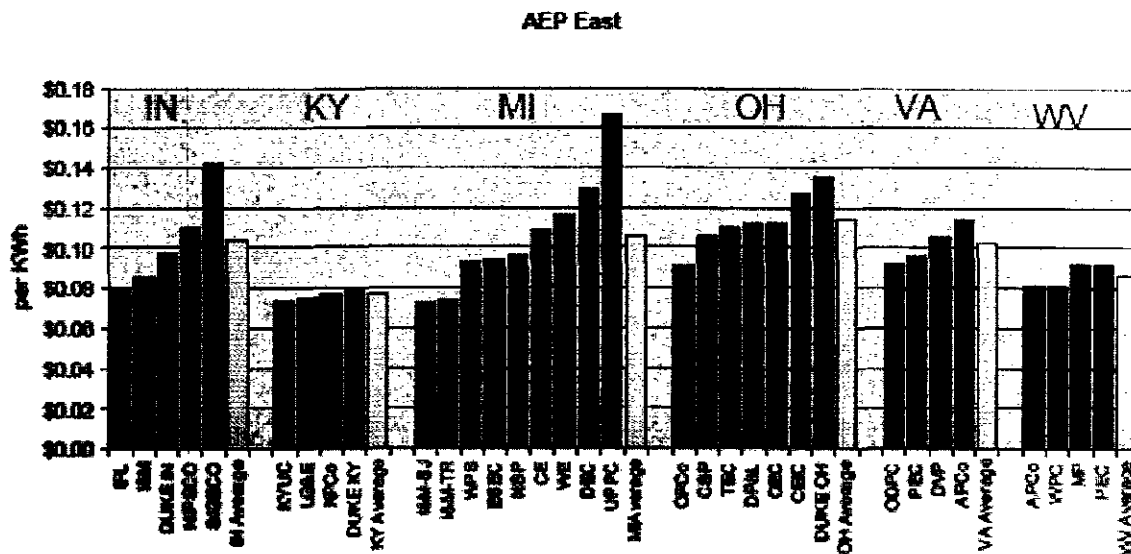
American Electric Power					
Financial Results for 3rd Quarter 2008 Actual vs 3rd Quarter 2007 Actual					
		2007 Actual		2008 Actual	
		Performance Driver	(\$ millions) EPS	Performance Driver	(\$ millions) EPS
<b>UTILITY OPERATIONS:</b>					
<b>Gross Margin:</b>					
1	East Regulated Integrated Utilities	18,677 GWh @ \$28.8 /MWh =	534	18,080 GWh @ \$27.8 /MWh =	499
2	Ohio Companies	13,464 GWh @ \$46.8 /MWh =	629	13,127 GWh @ \$43.9 /MWh =	577
3	West Regulated Integrated Utilities	12,468 GWh @ \$28.9 /MWh =	336	12,070 GWh @ \$28.2 /MWh =	341
4	Texas Water	7,721 GWh @ \$19.6 /MWh =	152	7,961 GWh @ \$19.3 /MWh =	153
5	Off-System Sales	10,164 GWh @ \$32.4 /MWh =	329	9,777 GWh @ \$33.0 /MWh =	322
6	Transmission Revenue - 3rd Party		81		85
7	Other Operating Revenue		128		150
8	Utility Gross Margin		2,187		2,127

The evidence in the more recently litigated significantly excessive earnings test ("SEET") case<sup>37</sup> shows that the revenue collected by AEP-Ohio in 2009 produced an even higher gross margin both in absolute terms and as compared to other AEP operating companies.

<sup>36</sup> IEU-Ohio Exhibit 2 is the 2008 earnings release presentation for the third quarter which was issued by AEP on October 31, 2008. Tr. Vol. IV at 285.

<sup>37</sup> *In the Matter of the 2009 Annual Filing of Columbus Southern Power Company and Ohio Power Company Required by Rule 4901:1-35-10, Ohio Administrative Code, Case No. 10-1261-EL-UNC, Application* (September 1, 2010) (hereinafter cited as "SEET Case").

The SEET record evidence shows that even though the costs of providing generating and transmission service are shared throughout the AEP-East system,<sup>38</sup> the rates in Ohio tend to be the highest among all the AEP-East operating companies. IEU-Ohio Exhibit 3 at 8 (a presentation that AEP made on June 23, 2010) shows residential rate comparisons for the AEP-East operating companies for 2009.<sup>39</sup>

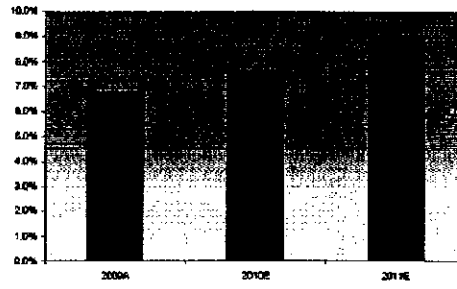


IEU-Ohio Exhibit 2 beginning at page 36 shows the AEP-East operating company (total company) earned returns on common equity for 2009 as well as estimated returns for 2010 and 2011. As Mr. Kollen explained, higher returns on common equity generally indicate higher electric rates. *SEET Case*, Tr. Vol. II at 392-393.

<sup>38</sup> The various pool agreements are described and discussed in AEP's Form 10-K, *SEET Case*, Companies Exhibit 3 at 12-19, C-1 (CSP) and E-2 (OP).

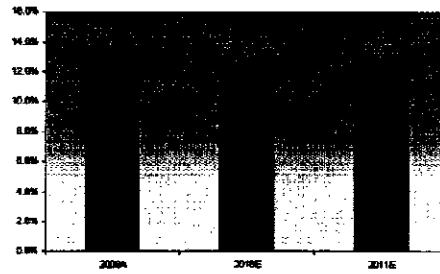
<sup>39</sup> This exhibit is from the *SEET Case*. As the Commission knows, OP's and CSP's 2010 rates are higher than the rates that were in effect in 2009.

Forecasted ROEs



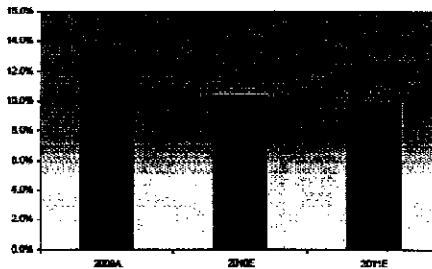
ROEs represent Appalachian Power and Wheeling Power

Forecasted ROEs



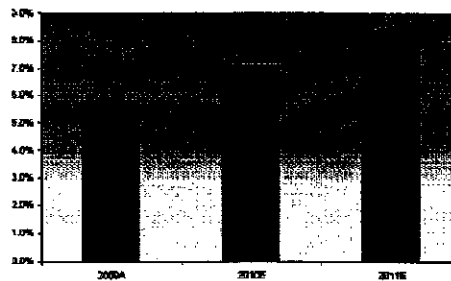
AEP Ohio (OP and CSP)

Forecasted ROEs



Indiana Michigan

Forecasted ROEs



Kentucky Power

AEP presentations such as the one designated as IEU-Ohio Exhibit 3 (*SEET Case*) also contain information on the relative level of gross margin that AEP collected in 2009 from the various divisions with the AEP system. As explained above, AEP computes gross margin by subtracting, from revenue, the related direct cost of fuel including consumption of chemicals, emission allowances and purchased power. *SEET Case*, Tr. Vol. II at 395.

2009 Actual: \$2.97		American Electric Power 2009 Actual vs. 2010 Guidance		2010E: \$2.80-\$3.20	
	Performance Driver	2009 Actual (\$ millions)	Performance Driver	2010 Guidance (\$ millions)	
<b>UTILITY OPERATIONS:</b>					
<b>Gross Margin:</b>					
1	East Regulated Integrated Utilities	66,976 GWh @ \$ 38.0 /MWhr = 2,544	66,249 GWh @ \$ 42.2 /MWhr =	2,878	
2	Ohio Companies	47,468 GWh @ \$ 57.6 /MWhr = 2,733	47,922 GWh @ \$ 63.6 /MWhr =	3,048	
3	West Regulated Integrated Utilities	36,947 GWh @ \$ 30.0 /MWhr = 1,167	41,165 GWh @ \$ 31.3 /MWhr =	1,287	
4	Texas Works	27,573 GWh @ \$ 20.7 /MWhr = 571	27,510 GWh @ \$ 22.2 /MWhr =	610	
5	Off-System Sales (net of sharing)	14,795 GWh @ \$ 16.7 /MWhr = 247	23,892 GWh @ \$ 13.7 /MWhr =	328	
6	Transmission Revenue - 3rd Party	354		352	
7	Other Operating Revenue	767		541	
8	Utility Gross Margin	8,383		9,045	
9	Operations & Maintenance	(3,410)		(3,620)	
10	Depreciation & Amortization	(1,561)		(1,637)	
11	Taxes Other than Income Taxes	(751)		(793)	
12	Interest Exp & Preferred Dividend	(919)		(957)	
13	Other Income & Deductions	128		148	
14	Income Taxes	(553)		(738)	
15	Utility Operations On-Going Earnings	1,317		1,450	
16	Transmission Operations On-Going Earnings	4		9	
<b>NON-UTILITY OPERATIONS:</b>					
17	AEP River Operations	47		43	
18	Generation & Marketing	41		2	
		\$2.97		(63)	
				1,441	

The above gross margin data (which AEP assembled and distributed to the public) show that the "Ohio Companies" (CSP and OP) provided a gross margin of \$57.6 per MWhr in 2009 and are expected to provide (as of June 23, 2010) \$63.6 per MWhr in 2010.<sup>40</sup> The actual per MWhr 2009 gross margin from the Ohio Companies was 51% higher than the per MWhr gross margin from the balance of the AEP-East operating companies. The next highest gross margin number anywhere within AEP is

<sup>40</sup> *SEET Case*, IEU-Ohio Exhibit 3 at 10.

\$38 per MWhr from the balance of the AEP-East Companies. In 2009, the Ohio Companies accounted for about 41% of combined Ohio Companies and East Companies GWh sales but over 51% of the comparable gross margin revenue.

## VII. A LESSON FOR THE FUTURE, PERHAPS

It appears that the Commission's summary approval of the POLR charge has, in part, provided AEP-Ohio with an opportunity to now claim that the hundreds of millions of dollars AEP-Ohio has collected through the POLR charge and other charges or riders, including capacity-related costs, do not provide sufficient compensation for capacity.

In the ESP Proceedings, AEP-Ohio proposed a non-bypassable distribution<sup>41</sup> POLR rider, asking for \$169.1 million annually to cover its alleged POLR risk.<sup>42</sup> AEP-Ohio characterized its POLR risk as a put (the risk of customers leaving AEP-Ohio's Standard Service Offer or "SSO") and a call (the risk of customers returning to AEP-Ohio's SSO), comparing customers' rights to leave AEP-Ohio and return to the SSO price to a series of options on power.<sup>43</sup> AEP-Ohio's requested POLR **distribution** revenue allowance was **not cost-based**, but rather relied on a model called the Black-Scholes Model to **hypothetically** select a **market price** to value AEP-Ohio's alleged POLR risk.<sup>44</sup>

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<sup>41</sup> Since AEP-Ohio proposed and the Commission approved the POLR charge as a **distribution** rider and **distribution** service is subject to the exclusive jurisdiction of the Commission, the Commission's rulings with regard to what compensation is provided by the POLR raise no issues that are subject to FERC's jurisdiction.

<sup>42</sup> *March 18 Order* at 38. See also *ESP Proceedings*, Application at 6-8 (July 31, 2008) (which includes the POLR request in the portion of AEP-Ohio's ESP that contains distribution-related proposals).

<sup>43</sup> See Tr. Vol. X at 211; see also *March 18 Order* at 39.

<sup>44</sup> Tr. Vol. X at 45.

Importantly, the hypothetical revenue calculation attributed by AEP-Ohio to the Black-Scholes Model and approved by the Commission did not vary regardless of whether 5% or 95% of customers shop and return to AEP-Ohio for generation service.<sup>45</sup> And, AEP-Ohio made it clear that even if the Commission granted its requested POLR-related revenue allowance, it was **not going to actually purchase insurance** to manage the alleged POLR risk.<sup>46</sup>

Over the objections of intervenors, the Commission found that AEP-Ohio has some POLR risk. The Commission then gave AEP-Ohio a revenue allowance of approximately \$152.2 million annually using the hypothetical market price and the workings of the blackbox Black-Scholes Model.<sup>47</sup> The Commission's March 18 Order in the ESP Proceedings states, based on the Commission's belief that AEP-Ohio has some risks associated with customers switching to CRES providers and returning to the EDU's SSO rate, that this risk is equivalent to 90% of AEP-Ohio's hypothetical quantification of such alleged risk.<sup>48</sup>

The Commission's March 18 Order ignored the opposing parties' demonstration that the Black-Scholes Model (as applied by AEP-Ohio) was invalid, did not include any actual costs of providing POLR, was tied to ridiculous assumptions about shopping, and relied on a market price (about \$88 to \$85 per MWH) which was rejected (implicitly) as

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<sup>45</sup> Tr. Vol. XI at 209-214; *see also* *ESP Proceedings*, Post-Hearing Brief Addressing Ohio Power Company and Columbus Southern Power Company Electric Security Plans by The Ohio Consumer and Environmental Advocates 27-28 (December 30, 2008).

<sup>46</sup> Tr. Vol. X at 212-213.

<sup>47</sup> *March 18 Order* at 40.

<sup>48</sup> *March 18 Order* at 40. The POLR revenue allowance authorized by the Commission was **180%** greater than the annual POLR revenue allowance that AEP-Ohio collected under its RSP.

being too high by the Commission for purposes of comparing the ESP and MRO options.<sup>49</sup>

AEP-Ohio's POLR proposal was advanced and approved by the Commission as a **distribution** charge. Despite the legal requirement that distribution charges be tied to identifiable and actual costs and set to provide "just and reasonable" compensation, the Commission authorized AEP-Ohio to collect hundreds of millions of dollars of POLR revenue based on a discredited model that manipulated hypothetical dollar-valued-inputs which, according to AEP-Ohio, provided compensation for the risk of standing by to provide full requirements service. The level of the POLR compensation was calculated assuming all customers would shop even though there was and is almost no shopping in OP's service territory and little shopping in CSP's service territory.

AEP-Ohio has eagerly taken this POLR compensation for more than two years and the Commission has not once required AEP-Ohio to reconcile the POLR revenue collection against the actual cost for the functional components that AEP-Ohio described as being the POLR components. It was clear at the time and it is even clearer in hindsight; POLR has provided AEP-Ohio with a windfall.

The total company earned returns on common equity provided by OP and CSP in the SEET proceedings show, by AEP-Ohio's own hand, that CSP and OP recovered all their costs (capacity and otherwise) plus earned a handsome profit.<sup>50</sup> In fact, in the

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<sup>49</sup> See *ESP Proceedings*, Application for Rehearing of Industrial Energy Users-Ohio at 15-19, 26-35 (April 16, 2009); Application for Rehearing of Ohio Consumers' Counsel at 29-34 (April 17, 2009); Initial Brief of Ohio Consumers and Environmental Advocates at 24-29 (December 30, 2008).

<sup>50</sup> As shown by the evidence in the SEET Case, CSP's earned return on equity for 2009 was the highest of any investor owned utility in the Nation.

Commission's Order recently issued on January 11, 2011 in the SEET proceeding, the Commission found that CSP had significantly excessive earnings and ordered CSP to return over \$42 million to its retail customers by way of regulatory asset reductions and future bill credits.

AEP-Ohio's Application seeks to take advantage of the Commission-encouraged mystery over what level of actual cost-based compensation is provided by the POLR revenue to argue that the POLR revenue does not provide compensation for capacity.

IEU-Ohio hopes that the Commission is mindful of this experience as it resolves other contested issues involving AEP-Ohio proposals. Commission-indulged mysteries about the purpose of compensation provided by the numerous riders and other compensation mechanisms are a playground for AEP-Ohio's profit enhancement ambitions. IEU-Ohio urges the Commission to put a quick end to AEP-Ohio's efforts to use the regulatory process and potential gaps between state and federal jurisdictions to secure approval of proposals that allow it to strategically flip flop between cost-based and market-based methods for developing compensation depending on which method produces the worst outcome for everybody but AEP-Ohio.

## **VIII. CONCLUSION**

Beyond whatever lessons may be gained from this experience, the Commission must either reject AEP-Ohio's Application as being without merit, grant rehearing and hold such hearing on the matter specified in such Application, or grant rehearing for the purpose of further considering the Application for Rehearing.<sup>51</sup> For the reasons

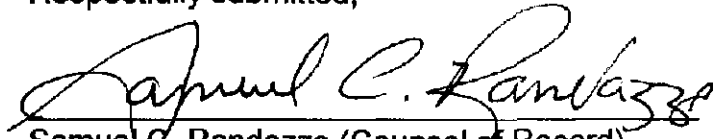
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<sup>51</sup> Section 4903.10, Revised Code.



previously provided and those contained herein, IEU-Ohio urges the Commission to reject AEP-Ohio's rehearing request and provide the relief requested in the Comments filed in this proceeding by IEU-Ohio on January 7, 2011.

Respectfully submitted,

A handwritten signature in black ink, reading "Samuel C. Randazzo". The signature is fluid and cursive, with the first name "Samuel" being the most prominent.

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## CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing *Industrial Energy Users-Ohio's Memorandum Contra Application for Rehearing* was served upon the following parties of record this 14<sup>th</sup> day of January 2011, via electronic transmission, hand-delivery or first class U.S. mail, postage prepaid.

  
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