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BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

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 No. 08-917-EL-SSO
In the Matter of the Application of Ohio Power Company for Approval of its Electric Security Plan; and an Amendment to its Corporate Separation Plan.	)	Case No. 08-918-EL-SSO

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INITIAL REMAND BRIEF OF INDUSTRIAL ENERGY USERS-OHIO

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INITIAL REMAND BRIEF OF INDUSTRIAL ENERGY USERS-OHIO

I. INTRODUCTION

The Ohio Power Company ("OPCo") and Columbus Southern Company ("CSP") (collectively, "Companies" or "EDUs" if the context applies) have once more failed to demonstrate that the Public Utilities Commission of Ohio ("Commission") can lawfully authorize the Companies to bill and collect standard service offer ("SSO") rates that include: (1) a revenue allowance for carrying charges on incremental environmental investments from 2001-2008 not previously recognized in rates or (2) a separately identifiable charge for satisfying the obligation of being the provider of last resort ("POLR").

In the March 18, 2009 Opinion and Order, the Commission approved an annual increase in the non-fuel generation rate of $26 million for CSP and $84 million for OPCo for carrying charges for incremental environmental investments from 2001-2008 and annual POLR charges of $97.4 million for CSP and $54.8 million for OPCo.[1] These unlawful charges were authorized and collected during a period of great financial difficulty for Ohio's citizens. While Ohio was suffering through the Great Recession, CSP in particular was found to have "significantly excessive earnings."[2]

As a result of the Companies' failure to demonstrate that the environmental carrying and POLR charges are lawful, the Commission must remedy the unlawful rates. More specifically the Commission must direct the Companies to file revised tariffs removing the unlawful amounts, order refunds or credits for the amounts currently being collected subject to refund, and flow through the remedial consequences into any future rates and charges that would be less as a result of the removal of the unlawfully authorized revenue.

II. BACKGROUND

The Companies are obligated to provide an SSO under Section 4928.141, Revised Code, in the form of a market rate offer ("MRO") under Section 4928.142, Revised Code, or an electric security plan ("ESP") under Section 4928.143, Revised Code. On July 31, 2008, OPCo and CSP filed an Application to establish an ESP. As part of the Application, the Companies sought authority to increase SSO rates and charges for, among other things, carrying charges on environmental investments including investments made from 2001 to 2008. Additionally, the Companies sought to

[1] Opinion and Order at 24, 28, & 40 (March 18, 2009).

[2] *In the Matter of the Application of Columbus Southern Power Company and Ohio Power Company for Administration of the Significantly Excessive Earnings Test under Section 4928.143(F), Revised Code, and Rule 4901:1-35-10, Ohio Administrative Code*, Case No. 10-1261, Opinion and Order (January 11, 2011).

increase SSO rates by the amount of a proposed POLR charge. In the Application, the Companies clearly identified that the POLR charge proposal was related to their distribution service.[3] At no time in the Application, in any prior testimony, the Companies' numerous briefs, other pleadings or the testimony sponsored by the Companies in this phase of these proceedings, have the Companies identified the source of the Commission's authority to authorize the proposed POLR charge.

In an Opinion and Order issued on March 18, 2009, the Commission authorized a rate increase in the SSO rate of approximately $1.5 billion which included the recovery of revenues for 2001-2008 incremental environmental expenditures and a POLR charge. According to the Commission, "AEP-Ohio [would] be allowed to recover the incremental capital carrying costs that will be incurred after January 1, 2009, on past environmental investments (2001-2008) that [were] not presently reflected in the Companies' existing rates, as contemplated in AEP-Ohio's [Rate Stabilization Plan] Case."[4] Additionally, the Commission authorized a POLR charge that permitted the Companies to recover $152.2 million annually to address the concern that "the Companies do have some risks associated with customers switching to [Competitive Retail Electric Service ("CRES")] providers and returning to the electric utility's SSO rate at the conclusion of the CRES contracts or during times of rising prices," but modifying the Companies' proposal "such that the POLR rider will be based on the cost to the

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[3] Application at 6-8 (July 31, 2008).

[4] Opinion and Order at 28 (March 18, 2009).

Companies to be the POLR and carry the risks associated therewith, including the migration risk."[5]

The Industrial Energy Users-Ohio ("IEU-Ohio") and the Office of the Ohio Consumers' Counsel ("OCC") appealed the Commission's Opinion and Order, and the Ohio Supreme Court reversed and remanded the Commission's Opinion and Order on April 19, 2011. In its decision reversing and remanding the Opinion and Order, the Supreme Court found that the Commission had unlawfully and retroactively allowed the Companies to increase SSO rates. It also rejected the Commission's and the Companies' legal argument that Section 4928.143(B)(2), Revised Code, provided the Commission with authority to authorize recovery of carrying charges for environmental investments made in 2001-2008. In response to the Commission's and the Companies' assertion that the phrase "without limitation" in Section 4928.143(B)(2), Revised Code, allows the Commission to authorize the Companies to bill and collect the environmental carrying charges,[6] the Court held:

> [T]his phrase does not allow unlisted items. Rather it allows unlimited inclusion of listed items. The list limits *the type* of categories a plan may include, while the phase 'without limitation' allows *as many or as much* of the listed categories as the commission finds reasonable—subject to any other applicable limits, which we do not consider here.[7]

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[5] *Id.* at 40.

[6] *In re Application of Columbus Southern Power Co.*, 128 Ohio St.3d 512, 520 (2011). ("*Remand Decision*")

[7] *Id.* (emphasis in original).

The Court then remanded the issue to the Commission, indicating that "the commission may determine whether any of the listed categories of (B)(2) authorize recovery of environmental carrying charges."[8]

The Supreme Court also reversed and remanded the Commission's decision authorizing a POLR charge. In reaching that conclusion, the Court referenced its earlier rulings related to the POLR obligation in which the Court concluded that the POLR function is limited to providing *returning customers* with SSO service: "The obligation to stand ready to accept returning customers makes the utility the 'provider of last resort,' or 'POLR.'"[9] The Court also observed that it had previously "admonished the commission to 'carefully consider what costs it is attributing' to 'POLR obligations.'"[10]

After a careful review of the record, the Court then tested the Commission's finding that the POLR charge was cost-based against the Commission's and the Companies' reliance upon a Black-Scholes valuation method to establish the POLR charge. The Court concluded that the Black-Scholes valuation method proposed by the Companies and adopted by the Commission to set the POLR charge "simply does not reveal 'the cost to the Companies to be the POLR and carry the risks associated therewith.' The record shows that the model does not even purport to estimate costs, but instead tries to quantify 'the value of the optionality [to shop for power] that is provided to customers under Senate Bill 221.' Value to customers (what the model shows) and cost to AEP (the purported basis of the order) are simply not the same

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[8] *Id.*

[9] *Id.* at 517, citing *Constellation New Energy, Inc, v. Pub. Util. Comm.*, 104 Ohio St.3d 530 n.5 (2004).

[10] *Id.* at 518, citing *Ohio Consumers' Counsel v. Pub. Util. Comm.*, 114 Ohio St.3d 340, 346 (2007).

thing."[11] The Court continued: "Even assuming that AEP accurately priced the option, we fail to see how the amount a customer would be willing to pay for the right to shop necessarily establishes AEP's costs to bear the attendant risks. The order does not explain the relationship between the two. And witnesses for other parties confirmed that the POLR charge was not based on cost."[12] The Court concluded that "the manifest weight of the evidence contradicts the commission's conclusion that the POLR charge is based on cost."[13] Therefore, the Court reversed the provisions of the Commission's ESP order authorizing the POLR charge.

As things presently stand, the POLR charge is unlawful, but the Court gave the Commission the option of considering the matter further.

> On remand the Commission may revisit this issue. To be clear, we express no opinion on whether a formula-based POLR charge is *per se* unreasonable or unlawful, and the commission may consider on remand whether a non-cost-based POLR charge is reasonable and lawful. Alternatively, the commission may consider whether it is appropriate to allow AEP to present evidence of its actual POLR costs. However the commission chooses to proceed, it should explain its rationale, respond to contrary positions, and support its decision with appropriate evidence.[14]

As a result of the Supreme Court's decision, the Commission initially ordered the Companies to file revised tariffs removing the revenue effects of the environmental carrying charges and POLR charges.[15] The Companies protested[16] and filed a motion

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[11] *Id.* at 518.

[12] *Id.*

[13] *Id.* at 519.

[14] *Id.*

[15] Entry (May 4, 2011).

[16] Application for Rehearing (May 6, 2011).

seeking an opportunity to argue for continuation of the charges and to collect the charges subject to refund.[17] On May 25, 2011, the Commission ordered the Companies to collect revenues associated with the POLR charges and the environmental carrying charges subject to refund.[18] Additionally, the Commission established a procedural schedule to take additional evidence.

The remand hearing began on July 15, 2011, and the Companies presented five witnesses. None of the direct testimony sponsored by the Companies discussed the remedy that the Commission should adopt as a result of the Ohio Supreme Court's decision and the Companies' failure to demonstrate that it was lawful for the Companies to collect the POLR and 2001-2008 environmental carrying charges. The intervenors (and more specifically, OCC and IEU-Ohio) sponsored testimony by six witnesses, and the Commission staff sponsored one witness who addressed problems with some of the Companies' Black-Scholes inputs while carefully making it clear that he was not suggesting that the Black-Scholes model was fit for the Companies' purpose.[19]

At the conclusion of the Companies' case, IEU-Ohio moved to dismiss the Companies' latest request that the Commission authorize the collection of 2001-2008 environmental carrying charges and the POLR charges and OCC joined the motion.

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[17] Columbus Southern Power Company's and Ohio Power Company's Combined Motion and Memorandum in Support to Establish a Procedural Schedule for the Remand Proceeding and to Reject or Hold in Abeyance the Tariffs Filed on May 11, 2011, and Motion to Prospectively Convert the Affected Rates to Being Collected Subject to Refund, and Request for Expedited Ruling on Both Motions (May 11, 2011).

[18] Entry at 3-4 (May 25, 2011).

[19] Commission Staff Remand Ex. 1.

The Attorney Examiners did not rule on the motion to dismiss.[20] For reasons discussed below, that motion should be granted as a predicate for the Commission directing the Companies to remedy the unlawful rates that are presently in effect subject to refund.

Issues regarding the scope of the remand hearing also were addressed through prehearing motions. IEU-Ohio filed a motion on May 10, 2011 asking that the Commission address the flow-through effects of the Supreme Court's decision on the deferrals that had accumulated on the books of the Companies as well other issues such as the determination of delta revenues for the Companies' Economic Development Rider ("EDR") and the Universal Service Fund ("USF") Rider.[21] Over repeated objections of the Companies, the Commission agreed that the hearings would address the effects of the Supreme Court's decision and permitted the parties to present evidence on the issue of the appropriate remedies if the Commission found that the Companies' revenues and deferrals must be adjusted as a result of the Supreme Court's reversal and remand of the March 18, 2009 Opinion and Order.[22]

III. SUMMARY OF THE IEU-OHIO ARGUMENT

Based on the record developed in the remand hearing, the Companies have failed to demonstrate that their proposal to increase SSO rates for the 2001-2008 environmental carrying charges and the POLR charges is lawful. The only testimony offered by the Companies to satisfy their burden of proof with regard to the 2001-2008

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[20] Remand Hearing Tr. Vol. 5 at 897 ("Tr."). References to the 2008 hearing are identified by the year of the hearing.

[21] Motion Requesting Commission Orders to Bring the Electric Security Plans of Ohio Power Company and Columbus Southern Power Company into Compliance with the Ohio Supreme Court's Decision and Other Relief (May 10, 2011).

[22] Entry on Rehearing (June 22, 2011); Entry at 6-7 (July 19, 2011) (granting in part and denying in part Companies' motion to strike testimony).

environmental carrying charges amounts to a naked reference to code subdivisions. The Companies made no attempt to demonstrate facts and circumstances that permit the Commission to rely upon any of those subdivisions to lawfully approve the carrying charges. As a result, the Companies have provided no basis to indicate what provision of Section 4928.143(B)(2), Revised Code, supports an authorization in an ESP for carrying charge revenues associated with environmental investments made prior to 2009.

Although the Companies presented a more complex approach to their claim for POLR charges, they failed to address the questions remanded by the Court. Initially, they fail to explain the legal basis for their claim to collect the separate charge. Moreover, they have failed to respond to the issues presented in the prior hearing and the remand hearing concerning the basis that they have incurred a cost to stand ready to serve returning customers. The Supreme Court's decision offered the Companies the alternative of either demonstrating a non-cost basis supporting the POLR charges or an opportunity to demonstrate the actual costs of providing POLR service. As the testimony demonstrated, the Companies made no attempt to calculate the actual costs they incurred to stand ready to serve any returning customers. The Companies instead chose to attempt to resuscitate their unreliable "valuation" method while protesting any attempt to look at actual costs or actual shopping to test the reliability of the valuation method. The Companies accompanied their retreat to a valuation model with their previously rejected argument that the value that customers derive from the choice given to them by the General Assembly is somehow equal to the cost that the Companies incur to meet the POLR function. In other words, the Companies ignored the Ohio

Supreme Court's holdings on their way to seeking compensation simply because customers have a right (whether exercised or not) to obtain generation supply from a CRES supplier and, perhaps, return to the Companies' SSO service. Moreover, the POLR compensation requested by the Companies is tied to a valuation method that does not even pretend to measure the cost incurred by the Companies to satisfy the POLR obligation as defined by the Court. Beyond attempting to bend the formula to a use for which it was not designed, the Companies implemented the method (or more properly "formula") in a manner so inconsistent with the assumptions driving the formula as to render the results meaningless.

Because the Companies failed to demonstrate any proper basis to include either the 2001-2008 environmental investment carrying charges or POLR charges in their SSO rates, the Commission must now fully remedy the unlawful rates. Regarding current rates, the Commission must order the Companies to file new tariffs removing the revenue effects of the items the Supreme Court found were unlawfully included and which the Companies have failed to justify in this remand hearing. Additionally, the Companies must refund or credit to customers amounts that have been collected subject to refund since the start of the June 2011 billing cycle with appropriate interest for the loss of the use of the funds. Finally, the Commission should direct the Companies to restate current deferrals and other regulatory assets to properly account for the flow-through effects of the Court's decision.

IV. THE COMPANIES HAVE FAILED TO DEMONSTRATE THAT THE 2001-2008 INCREMENTAL ENVIRONMENTAL INVESTMENT CARRYING CHARGES ARE LAWFUL

In reversing the Commission's Opinion and Order authorizing the Companies to include in their SSO rates carrying charges on 2001-2008 incremental environmental investments (identified by Joseph Bowser, the IEU-Ohio witness who addressed this matter as the "Pre-2009 Component" of environmental carrying costs), the Supreme Court found that any claim for additional revenues must be based on one of the listed items of Section 4928.143(B)(2), Revised Code. "So if a given provision does not fit within one of the categories listed 'following' (B)(2), it is not authorized by statute."[23] Having rejected the Companies' and the Commission's legal theory for including the Pre-2009 Component in the Companies' SSO rates, the Court went on to state that "the commission may determine whether any of the listed categories of (B)(2) authorize recovery of environmental carrying charges."[24]

As an initial matter, the Companies through the entirety of these proceedings have made no claim that the revenue from the other rates and charges is inadequate to compensate the Companies for any carrying charges on the Pre-2009 Component. This is no small defect, given the Commission's prior rulings on the Companies' proposed charges which the Commission rejected because the Companies failed to make such a demonstration. Also, the non-cost based charge authorized by Section 4928.143(B)(1), Revised Code, not Section 4928.143(B)(2), Revised Code, addresses

[23] *Remand Decision*, 128 Ohio St.3d at 520.

[24] *Id.*

the supply and pricing of electric generation service. The Pre-2009 Component is, of course, investment in generation facilities.

In its response to the Commission's invitation to the Companies to support a recovery of the Pre-2009 Component, Philip Nelson, the Companies' only witness on the issue, asserted based on advice of counsel that there were three bases for justifying recovery, suggesting that subdivisions (B)(2)(b), (d), and (e) of Section 4928.143, Revised Code, permitted recovery.[25]

The attempt by the Companies to justify the revenues for the Pre-2009 Component does not respond to the Supreme Court's concerns. Initially, the Companies did not make any demonstration that the Pre-2009 Component is recoverable under any of the provisions cited by Mr. Nelson. As IEU-Ohio witness Joseph Bowser explained, it takes more than a simple reference to the provisions in the law to trigger the Commission's authority to include proposed charges in the SSO rates. "The lack of specificity is important because each category has criteria that must be applied to make a charge eligible for inclusion in an ESP. As in the case of many accounting determinations, including, for example, those associated with identifying expenses that are eligible for deduction when computing taxable income, the eligibility criteria must be applied before eligibility can be determined."[26] The Companies offered no rebuttal testimony on this point. Thus, the Companies have failed to offer the necessary proof to support the claim for revenue recovery for the Pre-2009 Component.

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[25] Cos. Remand Ex. 2 at 4.

[26] IEU-Ohio Remand Ex. 3 at 8.

This lack of supporting testimony is not surprising, given that the language in the statutory sections Mr. Nelson referenced in his direct testimony do not support the Companies' claim that the Pre-2009 Component can be lawfully included in SSO rates under Section 4928.143(B)(2), Revised Code. For example, Section 4928.143(B)(2)(b), Revised Code, provides for recovery of expenditures related to construction work in progress ("CWIP") incurred or occurring after January 1, 2009. It specifically requires compliance with CWIP limitations in Section 4909.15, Revised Code, and the Companies have made no showing that they have satisfied Section 4909.15, Revised Code. In fact, there was no demonstration that the amount the Companies were seeking to recover were related to CWIP. Nor did the expenditures occur after January 1, 2009. As Mr. Nelson acknowledged, the expenditures for which the Companies are seeking carrying charges were incurred or occurred from 2001 to 2008. Section 4928.143(B)(2)(b), Revised Code, is directed at non-bypassable charges, not bypassable charges, as the Companies have proposed. And, the Companies have made no attempt to satisfy the requirements in Section 4928.143(C)(1), Revised Code; requirements that must be satisfied in the case of any surcharge authorized under Section 4928.143(B)(2)(b), Revised Code. Thus, the Companies have not shown that the requirements of Section 4928.143(B)(2)(b), Revised Code, have been met.

Section 4928.143(B)(2)(d), Revised Code, includes the words "carrying costs," but anything allowed under Section 4928.143(B)(2)(d) must have the "effect of stabilizing or providing certainty regarding retail electric service." Mr. Nelson's direct testimony does not mention how this requirement is satisfied.[27] Mr. Nelson's testimony did nothing more than reference Section 4928.143(B)(2)(d).[28]

Next, Mr. Nelson referenced Section 4928.143(B)(2)(e), Revised Code, which provides automatic increases and decreases in any component of an SSO price. By its terms, the Pre-2009 Component carrying charge proposed by the Companies has nothing to do with any automatic increases or decreases. The level of the Pre-2009 Component charge proposed by the Companies is simply bundled with the non-fuel adjustment clause ("FAC") base generation charge.[29] Also, before Section 4928.143(B)(2)(e) can be invoked, the Companies must first demonstrate that the component subject to automatic increases or decreases is eligible for inclusion in SSO rates under Section 4928.143(B)(2), Revised Code, a demonstration which the Companies have not attempted, let alone made.

In summary, the Companies have failed to demonstrate that there is a basis for recovering the Pre-2009 Component under Section 4928.143(B)(2), Revised Code. The Companies' testimony failed to offer any basis for recovery, and the terms of subdivisions suggested by the Companies' testimony are not satisfied. As a result, the Commission must fully remedy the unlawful inclusion of the charges in the current SSO rates.[30]

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[27] Mr. Bowser noted Mr. Nelson's failure to address this point in his testimony as well. IEU-Ohio Remand Ex. 3 at 8.

[28] Cos. Remand Ex. 2 at 4.

[29] IEU-Ohio Remand Ex. 3 at 8.

[30] The proper adjustments to rates and deferred revenues are discussed below.

V. THE COMPANIES HAVE FAILED TO DEMONSTRATE THAT THE POLR CHARGES ARE LAWFUL

The legitimacy of claims for POLR charges has been an ongoing legal issue since the introduction of electric competition in Ohio. The Court had previously defined the POLR obligation and admonished the Commission that it "should carefully consider what costs it is attributing as costs incurred as part of an electric-distribution utility's POLR obligations."[31] In the *Remand Decision*, the Supreme Court followed its prior directives concerning the definition of the POLR obligation and after a detailed review of the record, determined that "the manifest weight of the evidence contradicts the commission's conclusion that the POLR charge is based on cost."[32] The Supreme Court then remanded the issue to the Commission to determine whether a non-cost-based POLR charge is reasonable and lawful or, alternatively, the Commission could consider whether it was appropriate to allow the Companies to present evidence of their actual POLR costs.[33] The Supreme Court then advised the Commission that "[h]owever [it] chooses to proceed, it should explain its rationale, respond to contrary positions, and support its decision with appropriate evidence."[34] In response to the Supreme Court's decision, the Commission directed that the Companies and the intervenors should be afforded the opportunity to present testimony and to offer additional evidence

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[31] *Ohio Consumers' Counsel v. Public Util. Comm'n of Ohio*, 114 Ohio St.3d 340, 346 (2007).

[32] *Remand Decision*, 128 Ohio St.3d at 519.

[33] *Id.*

[34] *Id.*

concerning the POLR charge and that "[t]he parties may address the amount of POLR charges at issue."[35]

The record before the Commission consists of two pieces. The Commission has before it the Companies' justification for the POLR charge they proposed and the criticism of that rationale offered in the 2008 hearing. In the 2008 hearing, the Companies attempted to justify its POLR charge on the basis that a Black-Scholes option pricing formula properly values the optionality of the customer's right to choose to leave SSO service. The Companies offered no evidence of an identifiable cost of providing POLR service, and further defined the POLR obligation as being related to both the risk of loss of customers to competition and the risk of those customers returning to the SSO.[36]

In response, the parties presented a substantial and ultimately effective critique of the Companies' POLR charge proposal. For example, OCC and others questioned the use and implementation of the Black-Scholes formula to set the charge.[37] As noted in the Opinion and Order, Commission staff challenged the Companies' definition of the POLR risk, noting that the Companies were seeking to recover for the risk of migration, essentially the risk that all competitors face when their prices are above market.[38] The Commission also noted at least one problem raised concerning the failures inherent in the formula.[39] The Commission's Opinion and Order, however, failed to discuss the

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[35] Entry at 4 (May 25, 2011).

[36] Opinion and Order at 38-39.

[37] *Id.* at 39.

[38] *Id* at 39.

[39] *Id.* at 40.

additional significant criticisms raised by the parties.[40] In the end, however, the record from the 2008 hearing, as the Supreme Court has already determined, did not demonstrate that the Companies carried the burden of demonstrating that the POLR charge is cost-based. As the Supreme Court concluded, the Companies' valuation method "simply does not reveal 'the cost to the Companies to be the POLR and carry the risks associated therewith.'"[41] As the decision stated, "[v]alue to customers (what the model shows) and cost to AEP (the purported basis of the order) are simply not the same thing."[42]

Undeterred by the Supreme Court's admonition that "value" to customers does not equal "cost" to the Companies, they assume a legal right to POLR charges without any demonstration of where that right is created. They also have continued to advocate that the Commission adopt the formula-derived value of the option as the "cost" of the POLR in the remand hearing. Presenting three witnesses to justify a "cost-based" POLR charge, the Companies attempted to dress up the results of applying the Black-Scholes formula as the cost to the Companies of the risk of being the POLR. As was demonstrated repeatedly throughout the remand hearing, the amounts that the Companies are seeking to recover are not related to the financial risk, if any, that might arise from the statutory requirement to provide the SSO to returning customers, the Companies have not demonstrated that they have incurred any costs to provide that

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[40] *Id.*

[41] *Remand Decision*, 128 Ohio St.3d at 518.

[42] *Id.*

service, and the formula on which the Companies again seek to base the POLR charge is neither the correct tool nor applied in a way so as to provide any meaningful results.

A. The Legal Authority to Charge for the POLR Obligation Was Not Demonstrated

As an initial matter, the Companies have not demonstrated any legal authority to support the POLR charge. The Companies originally proposed the charge as a distribution rider, as noted in the Opinion and Order.[43] Similar to the Companies' approach on their request to recover the Pre-2009 Component, the Companies apparently assume that they are entitled to a POLR charge with no demonstration of any statutory support. Clearly, the rider would not qualify for recovery under the requirements of Section 4928.143(B)(2)(h), Revised Code, as the POLR charge has nothing to do with the distribution charges that could be authorized under that subdivision. Likewise, nothing in the Application or remand case offered by the Companies indicates what basis, if any, would qualify the charge as a generation-related rider. Absent such a demonstration, the Commission may not authorize a POLR charge.[44]

B. The POLR Obligation Defined

Apart from the lack of any indication of the Companies' legal basis for the POLR charge, the Companies have also failed to properly define the POLR obligation in a manner consistent with the *Remand Decision*. In the *Remand Decision*, the Supreme Court defined the scope of the POLR obligation: "Under Ohio law, customers may purchase generation service from a competitive supplier. If such a supplier fails to

[43] Opinion and Order at 38.

[44] *Id.* at 520.

provide service, 'the supplier's customers . . . default[ ] to the utilities' standard service offer . . . until the customer chooses an alternative supplier.' [Citation omitted.] This obligation to stand ready to accept returning customers makes the utility the 'provider of last resort,' or 'POLR.'"[45] As the Supreme Court previously explained, "POLR costs are those costs incurred by [the utility] for risks associated with its legal obligation as the default provider, or electricity provider, of last resort, for customers who shop and then return to [the utility] for generation service."[46]

In describing what they are attempting to measure through their valuation approach, however, the Companies have explicitly defined the "POLR risk" as the risk associated with the loss of customers to competitive suppliers **and** the possible return of those customers.[47] A subtle but important difference between the POLR *obligation* the Court identified and the POLR *risk* the Companies identified emerged in the testimony. When questioned, both Ms. Thomas and Dr. LaCasse reemphasized that the models they relied upon were designed to measure costs due to migration away from SSO service.[48] The Companies' definition is consistent with the Companies' description of its model in the 2008 hearings in which Companies' witness Craig Baker assigned 90% of their proposed POLR charge to the losses the Companies would incur due to migration of customers to CRES providers.[49]

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[45] *Id.* at 517.

[46] *Constellation New Energy, Inc. v. Public Util. Comm'n of Ohio*, 104 Ohio St.3d 530 n.5 (2004).

[47] Cos. Remand Ex. 4 at 3; Cos. Remand Ex. 3 at 5-7 and 14.

[48] Tr. Vol. I at 153 (LaCasse); Tr. Vol. II at 268 (Thomas).

[49] Opinion and Order at 40 (March 18, 2009).

As bad as the model was (again) shown to be in its inability to capture any of the relevant costs of standing ready to provide service to returning customers, the Companies' definition of the POLR obligation was and is legally wrong. The Supreme Court's definition of the POLR obligation excludes any claim for recovery for any risk of customers migrating to a CRES provider; the POLR obligation is "to stand ready to accept returning customers."[50] As noted above, the Companies simply ignored this definition to the detriment of everything that followed in their testimony.[51]

In contrast to the Companies' attempt to redefine the POLR obligation to encompass their risk of losing customers to lower-priced CRES providers, the intervenor witnesses consistently started from the Supreme Court's definition of the POLR obligation. For example, IEU-Ohio witness Kevin Murray stated that the implementation of Ohio's electric restructuring legislation created an obligation to provide an SSO to consumers which included a firm supply of electric generation service.[52] This obligation to provide an SSO created no risk regarding the physical provision of service because all generation requirements are governed by the operations of PJM Interconnection, Inc.[53] Mr. Murray did recognize that the SSO obligation might create some financial risk for the EDU. As he noted, whether there is some financial risk would "depend[ ] on the structure of the SSO that OPCo and CSP

[50] *Remand Decision*, 128 Ohio St.3d at 517.

[51] The definition of the POLR obligation was discussed by Ms. Thomas in her remand testimony. *See* Cos. Remand Ex. 4 at 11-12. Ms. Thomas correctly quoted the various decisions she cited, but neglected to address the definition of the POLR obligation in the *Remand Decision* itself.

[52] IEU-Ohio Remand Ex. 2 at 3.

[53] *Id.* at 5-7.

elect to accept as part of an ESP."[54] The risk in the case of the Companies, however, was confined to the fixed portion of their SSO rates, and only if the fixed portions became more expensive than what would be recovered in rates.[55]

Any costs of the POLR obligation, however, are limited to a subset of the effects on the EDU of customer choice. As the Supreme Court explained, it is the "obligation to stand ready to accept returning customers" that makes the utility the POLR.[56] By this definition, the Commission is required to recognize a difference between the revenues an EDU may lose if customers migrate to a CRES provider and the costs the EDU may incur to stand ready to serve returning customers. As IEU-Ohio witness Dr. Jonathan Lesser explained: "Migration away from the SSO results when market prices are expected to be lower than the SSO price for the foreseeable future. This is a risk of competitive markets, not a risk of being a POLR provider."[57] Similarly, OCC witness Mack Thompson testified, "The revenue lost due to switching is a consequence of operating in a competitive market; it is not a risk that is unique to a distribution company providing POLR service and therefore it is not a consequence of being required to provide POLR service."[58] The difference between lost revenues associated with customers leaving an EDU's SSO service and the costs associated with a customer's return to SSO service is significant. As Mr. Thompson pointed out, compensating an

[54] *Id.* at 7.

[55] *Id.*

[56] *Remand Decision*, 128 Ohio St.3d at 517.

[57] IEU-Ohio Remand Ex. 1 at 13. The Commission Staff identified the migration risk separately from the risk of serving as the POLR in the 2008 hearings. 2008 Tr. Vol. XIII at 55-56 (Richard Cahaan).

[58] OCC Remand Ex. 1 at 11.

EDU for lost revenues due to customers switching to CRES providers "would essentially compensate the Companies for their risk of being non-competitive in the retail market and would advantage the Companies over their competitors. There is no reason for the Commission to favor one generation competitor in the market (in this case a distribution *company) over another competitor.*"[59]

As a legal matter, the attempt to redefine the POLR obligation to include this migration risk also would run afoul of other provisions of the Revised Code providing for customer choice. As part of the restructuring legislation contained in Amended Substitute Senate Bill 3 ("SB 3"), the Companies had the opportunity to identify generation transition costs that were prudently incurred, legitimate, verifiable, and directly assignable or allocable to retail electric generation service to which the EDUs would otherwise have been entitled an opportunity to recover, and, importantly, "unrecoverable in a competitive market."[60] These costs were then to be the basis for a transition charge for each class of customers and could be collected for a finite period, the market development period, which would end no later than December 31, 2005 unless otherwise modified.[61] Critically, once the transition period was over, Section 4928.38, Revised Code, provided that "the utility shall be fully on its own in the competitive market. The commission shall not authorize the receipt of transition revenues or any equivalent revenues by an electric utility except as expressly authorized by Section 4928.31 to 4928.40 of the Revised Code."[62]

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[59] *Id.* at 12.

[60] Section 4928.39, Revised Code.

[61] Section 4928.40, Revised Code.

[62] Section 4928.38, Revised Code (emphasis added).

Commission approval of the Companies' definition of the POLR risk would violate the limitation contained in Section 4928.38, Revised Code. Their proposed definition would allow them to recover the revenues that would not be available as a result of competition.[63] In anticipation of this very problem, the General Assembly precluded the authorization of the continuation of transition charges or any equivalent revenues after the conclusion of the market development period. In contrast, the definition of the POLR obligation that the Supreme Court provided in the *Remand Decision*, which limits the scope of the obligation to serve provided to only returning customers, recognizes that losses associated with the migration of customers to CRES suppliers is not properly within the scope of recovery and is consistent with a proper reading of Section 4928.38, Revised Code, which prevents the Commission from authorizing the recovery of any additional transition costs. As Dr. Lesser pointed out, the time for recovering losses due to competition has passed.[64]

The Court has provided a definition of the POLR obligation which is limited to the obligation of the EDU to stand ready to serve returning customers. Nothing in that definition suggests that losses associated with customer migration to CRES providers is

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[63] Dr. LaCasse's attempt at modeling the cost of POLR losses using the Monte Carlo method explicitly adopts this approach of calculating lost revenues. For migration losses, it calculates the difference between the SSO price and the CRES price to determine the lost revenues of the Company. For a class of customers returning to SSO service, it assumes the Companies will secure power at the higher market price that drives the customer class to return to the EDU and assumes that the EDU recovers the SSO price, thereby generating a revenue loss caused by the returning class of customers. Cos. Remand Ex. 5 at 9. Similarly, Dr. LaCasse concludes that the POLR risk of the Companies included lost revenues due to customer shopping. Cos. Remand Ex. 3 at 7; Tr. Vol. I at 141-42. When asked in rebuttal whether the Black-Scholes formula and her Monte Carlo simulation were definitionally different, she agreed that they were, but continued that the models "conceptually should get to the same result in that in both cases the models rely on the expected difference between the SSO price now and the prevailing market price as it may change." Tr. Vol. V at 693.

[64] IEU-Ohio Remand Ex. 1 at 12-13; Tr. Vol. III at 337.

permitted. To allow the definition to be transformed as suggested by the Companies would not only step beyond the legal parameters outlined by the Supreme Court's *Remand Decision*, but would further violate the statutory provision denying the Companies any claim to transition charges. Moreover, acceptance would be a significant setback to the goal of fostering competition in Ohio as the Companies would be held harmless for the lost revenues that are the result of SSO rates that are no longer competitive.

C. The Cost of the POLR Obligation

Apart from the definitional problem inherent in the Companies' case, the Companies also did not make any demonstration that they are not compensated for providing POLR service under their current SSO rates and did not calculate any out-of-pocket costs to stand ready to serve returning customers. In part, this may be based on the limited load that has been actually lost, which the Companies have stated is roughly 3% for CSP and negligible for OPCo,[65] thus severely limiting any claim that the EDUs face any significant risk that customers will be returning to SSO service. The Companies, however, went so far as to argue that there was no practical way to measure the after-the-fact cost of standing ready to serve returning customers.[66] Thus, the record is devoid of any evidence that the Companies have incurred a cost to serve returning customers.

Moreover, the current SSO rates likely cover any costs associated with the risk of serving returning customers. As Mr. Murray stated, the Companies might have a

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[65] IEU-Ohio Remand Ex. 6 at 31.

[66] Cos. Remand Ex. 8 at 3-4.

negative financial risk if the cost of providing service to the returning customer is greater than the fixed costs associated with providing service to that customer that already are embedded in the SSO rate.[67] As Mr. Thompson similarly demonstrated, "A customer returning from CRES will pay the SSO generation rate. The potential negative impact associated with a returning customer arises because a customer could return at a time when the cost of producing/purchasing power is higher than that assumed when the SSO rate was developed. The Companies may have a negative financial impact from being the POLR *only if there is a cost of providing service to a returning customer that is not already recovered through the remainder of the SSO rate structure*."[68] The exposure, however, is limited to only the portion of the rate related to fixed costs; the Companies have an opportunity to recover any variable costs such as fuel, including any purchased power, to serve the returning customers.[69]

As noted previously, however, the Companies did not provide any evidence that the SSO rates are not covering the Companies' fixed costs of providing SSO service. Moreover, it is unlikely the Companies can do so. As Mr. Thompson explained, the fixed costs of capacity were known when the Companies sought the current ESP rates, and the Companies were well positioned to incorporate those costs into their rates.[70] One of the Companies' own witnesses acknowledged that the Companies were not at

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[67] IEU-Ohio Remand Ex. 2 at 7.

[68] OCC Remand Ex. 1 at 13.

[69] *Id.* at 14-15. Company witness Chantale LaCasse agreed that the Companies recovered their fuel costs through the fuel adjustment clause. Tr. Vol. II at 226.

[70] OCC Remand Ex. 1 at 13.

risk for capacity payments.[71] Thus, not only does the record not support a determination that there is a need for a separate charge to recover the risk of returning customers, but the structure of the current ESP does not indicate how the Companies might be exposed to uncompensated costs for providing service to those customers.[72]

As an alternative to a calculation of the out-of-pocket cost of standing ready to serve returning customers, the intervenors and a Companies' witness also suggested ways in which the cost of meeting the POLR obligation (as defined by the Court) service could be determined. Mr. Murray, for example, offered that the risk of providing SSO service, or in the alternative only that service necessary for returning customers, could be auctioned to third parties whose bids would encapsulate the costs of the SSO service including any risk associated with the cost of customers returning to the EDU for SSO service.[73] Dr. LaCasse similarly suggested that bidding out the SSO service obligation to third parties would be a means of determining the cost of providing SSO service in a manner that would capture any cost associated with the risk of serving returning customers.[74] At this point, however, there is no proof of any attempt to identify POLR cost on this basis.

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[71] Tr. Vol. II at 223.

[72] A further consideration is whether the Companies are in fact unable to cover any losses or costs associated with either migration or the obligation to serve returning customers. As Mr. Murray pointed out, on the one hand, the Companies' costs in total have not been reviewed to determine if they have changed up or down in the last decade since the creation of the POLR obligation in SB 3. Tr. Vol. IV at 569. On the other hand, the Companies have represented in a Securities and Exchange Commission ("SEC") filing that they are attempting to manage lost generation gross margin through off-system sales ("OSS"). IEU-Ohio Remand Ex. 6 at 161.

[73] IEU-Ohio Remand Ex. 2 at 8, Tr. Vol. IV at 577-79.

[74] Cos. Remand Ex. 3 at 8-9.

Even within the framework in which they suggested that costs were incurred by the Companies, the Companies failed to indicate what those costs were. Dr. Makhija offered the theory that the costs would be reflected in the Companies' equity, but provided no factual support for the claim.[75] Dr. LaCasse offered that the "costs" would appear as lost revenues, but provided no demonstration of lost revenues that the Companies in fact lost. Instead, the Companies took the position that it would not be appropriate to determine the out-of-pocket costs to provide service to customers[76] and argued that after-the-fact determinations of the cost of providing a POLR charge would be a "speculative reenactment."[77]

In summary, the Companies have failed to demonstrate any actual costs of standing ready to serve returning customers. The failure of the Companies to respond to the Court's decision with evidence of the costs, however, was compounded by the Companies' further pursuit of the discredited Black-Scholes formula, as discussed below.

VI. THE COMPANIES' ALTERNATIVE MEANS FOR MEASURING THE NON-EXISTENT POLR RISK IS THE WRONG TOOL BADLY USED

The majority of the time in the remand hearing was spent deconstructing the Companies' proposal urging the Commission to adopt the same result that the Supreme Court rejected. The Companies' position was clearly stated by Ms. Thomas in her direct testimony: "[T]he Companies' filing and the Commission's order resulted in fair and

[75] Cos. Remand Ex. 1 at 4.

[76] Cos. Remand Ex. 8 at 2-4.

[77] *Id.* at 4.

reasonable POLR rates for customers."[78] To that end, the Companies provided what appears to be the following argument in their attempt to demonstrate that they are incurring a "cost" to satisfy the POLR obligation: (1) The value to customers of being able to leave the SSO and return to it is equal to the cost of the POLR to the Companies; (2) the cost of the POLR to the Companies can be determined by the Black-Scholes option pricing formula; (3) the results of the Black-Scholes option pricing formula are sufficiently "close" to the results derived from an "improved" constrained Black formula, the implied costs identified in other state-sponsored default service auctions, and the results of a Monte Carlo simulation to justify charging customers $456 million over the life of the ESP. As discussed below, none of the three steps in the Companies' case was correct or proved.

A. The Value of the Option Does Not Equal the Cost to the Companies

In their attempt to justify their current POLR charges as cost-based, the Companies offered that the value of the option to leave and return to the SSO to customers represents the cost to the Companies to serve as the POLR. This remarkable and wrong assertion had been previously rejected by the Supreme Court in the *Remand Decision*,[79] but the Court noted that the Commission's Opinion and Order failed to explain the relationship between the value of the optionality and the cost to the

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[78] Cos. Remand Ex. 4 at 16.

[79] *Remand Decision*, 128 Ohio St. 3d at 518 ("The record shows that the model does not even purport to estimate costs, but instead tries to quantify 'the value of the optionality [to shop for power] that is provided to customers under Senate Bill 221.' Value to customers (what the model shows) and cost to AEP (the purported basis of the order) are simply not the same thing. AEP's own witness made this clear—'[t]rying to recover *the costs of the Companies' POLR obligation* retrospectively would fail, because it ignores the very nature of the POLR obligation. The *value of the customers' right to switch* under S.B. 221 comes from the option customers are given to switch supplies while still having the safety net of the ESP rate . . . .'").

Companies. Through the testimony of Dr. Makhija, the Companies apparently sought to explain the relationship.[80] Dr. Makhija offered the following: "Since the benefits of a POLR obligation to customers of a utility represent costs that the utility bears, the value of the options given to the customers equals the POLR costs to the utility. ... The cost to the utility that provides the POLR optionality is no more or less than the value of the options received by the customers."[81] He then extended the argument to assert that even if the Companies did not incur any out-of-pocket costs they would nonetheless suffer a negative change in their equity value.[82] The loss in equity value that Dr. Makhija asserted would occur, however, apparently was highly theoretical. Dr. Makhija had not done any empirical work to demonstrate the effect and was not aware of any empirical work that would support his argument.[83] Apart from the unsupported claim that equity value might be affected, what was true when the Supreme Court remanded this case remains true: value to customers is not the same thing as cost to the Companies.

As Dr. Lesser explained through his example of the value of a bottle of water to the thirsty buyer and the cost of the bottle of water to the seller, the suggestion that value to the customer equals the cost to the seller is economic nonsense. In a market, the fact that a transaction occurs demonstrates that the customer values the item being purchased more than the price the seller demands.[84] But more importantly, the

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[80] *Id.*

[81] Cos. Remand Ex. 1 at 3-4.

[82] *Id.* at 4.

[83] Tr. Vol. I at 18, & 20-22.

[84] IEU-Ohio Remand Ex. 1 at 12-15.

transaction is completed because the seller covers his costs.[85] The value to the customer, thus, has nothing to do with the price the seller must charge to cover his economic cost of providing the good.

In response to this basic understanding of how markets are supposed to work, the Companies seem to suggest that options are different. Presenting her own example of a customer buying a bottle of water, Dr. LaCasse attempted to demonstrate that option's value to the customer equals the cost to the seller of the option. The example provided by Dr. LaCasse on behalf of the Companies, however, merely perpetuates the logical flaw underlying the Companies' argument that the value of the option equals the cost to the Companies. In her example, the buyer has an option to buy water, but chooses a lower cost seller's product. She assumes correctly that the existence of an option creates value for the purchaser of the option.[86] The loss she attributes to the option seller, however, is the lost revenues associated with the customer choosing the alternative lower cost provider.[87] There is no cost identified in her example. Only by implying that lost revenues are costs and are recoverable can she make the argument that some sort of equality exists between value and cost. Further, her example also ignores some obvious realities: the Companies can mitigate the reductions to gross margins by OSS, and lost revenues are not recoverable as a cost of standing ready to serve a returning customer. Moreover, Dr. Lesser's testimony anticipated and refuted the assertion that an option is somehow different from the sale of the related asset: the

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[85] *Id.* at 15. *See, also*, OCC Remand Ex. 1 at 37.

[86] Cos. Remand Ex. 5 at 5.

[87] *Id.* at 6.

same economic principles apply to the purchase of an option as apply to the purchase of a bottle of water by a thirsty person in the desert.[88]

In summary, the first proposition supporting the Companies' argument that the option model identifies cost to the Companies is wrong. Its economic logic is counterintuitive and apparently based on a misunderstanding that lost revenues are costs of standing ready to provide SSO service to returning customers. Thus, the first proposition of the Companies' argument should be rejected.

B. The Companies' Implementation of the Black-Scholes Formula Is Fatally Flawed

Even if the first proposition that the option value equaled the Companies' costs could somehow be demonstrated, the Companies' use of the Black-Scholes option pricing formula is so fundamentally flawed as to render the results meaningless. First, the formula, if it measures anything, measures lost revenues, not costs. Second, it will always overstate the lost revenues. Third, the assumptions that are required to use the formula properly are not demonstrated in the Companies' application of it. Taken together, these concerns should lead the Commission to reject the use of the Companies' attempt to value the optionality as a basis for setting a POLR charge.

First, the formula used by the Companies to calculate the proposed POLR charge attempts to determine lost revenues instead of the cost of standing ready to provide service to returning customers. As Dr. LaCasse explained, the "costs" the formula attempts to identify are the lost revenues that result from the Companies'

[88] *Id.*

inability to hedge for migrating customers.[89] As described, the formula used by the Companies does not purport to measure the cost of standing ready to serve customers returning to SSO service.

Because the formula attempts to calculate anticipated lost revenues, it is important to recognize that there are no costs associated with migration of customers to CRES providers. As Mr. Murray testified, "The Companies do not incur any actual out of pocket costs when a customer elects to receive service from a CRES provider. The Companies may see a decline in the amount of revenue that they can bill and collect in this circumstance."[90] Fundamentally, then, the formula does not measure a cost at all.

Even if measuring lost revenues were the appropriate measure of the POLR obligation, the Companies' use of the formula would overstate the lost revenues. As Mr. Murray indicated, the Companies modeled a put option, an option that gives them the opportunity to sell power at a particular price, but they failed to account for revenues they would receive through the Fixed Resource Requirement ("FRR") election with PJM. This election requires that any CRES providers pay the Companies for capacity the CRES providers' customers use.[91] As noted previously, moreover, the Companies would not incur any fuel costs. Thus, the lost revenues defined by the Companies' formula are overstated.

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[89] Cos. Remand Ex. 3 at 12 ("The value of the option is essentially the expected value of the difference between the ESP price and the market price at which customers choose to shop. This is also the amount by which realized revenue for the EDU can be expected to be below the ESP revenue that the EDU would have received absent the customer shopping.").

[90] IEU-Ohio Remand Ex. 2 at 9.

[91] *Id.* at 15-19.

The overstatement is especially egregious when a comparison is made between the results of the formula and the actual reduced gross margins the Companies reported for 2010 and anticipated for 2011. As reported to the SEC, CSP saw reductions in gross margins of $16 million in 2010, and anticipated reductions in gross margins of $54 million in 2011. The Companies anticipated making up some of those reductions through OSS.[92] OPCo suffered negligible changes in its load in 2010.[93] In contrast, the Companies' formula resulted in a revenue increase for the Companies of $152 million annually.[94] The discrepancy between the formula's results and the actual reported changes in gross margin (and not accounting for any offsets resulting from revenue obtained by the Companies from other sales made possible by the loss of SSO customers) demonstrates how poorly the formula anticipated the revenue effect of shopping customers. If this were allowed to continue, not only would the formula be measuring the wrong thing, but the results of the formula would be grossly out of line with known effects of the thing being measured. A sillier exercise is hard to imagine.

Finally, it is not surprising that the formula produces ridiculous results because, apart from the fact that it is measuring the wrong thing and overstating what is being measured, the necessary assumptions[95] for using the formula are violated in multiple ways.

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[92] IEU-Ohio Remand Ex. 6 at 161. Gross margin is defined as revenues less the related direct cost of fuel, including consumption of chemicals and emission allowances, and purchased power. *Id.* at 13.

[93] *Id.* at 31.

[94] Opinion and Order at 40 (March 18, 2009).

[95] Dr. Lesser provides the assumptions on which the Black-Scholes model is based. IEU-Ohio Remand Ex. 1 at 18 ("1. Markets are perfect and there are no transaction costs. 2. Price volatility is constant. 3. The risk-free interest rate is constant over time. 4. The strike price is constant. 5. The returns on the

- The formula assumes that markets are perfect and without transaction costs. As both Dr. Lesser and Mr. Murray indicated,[96] there are in fact significant transaction costs in making changes to and from SSO service.
- The formula assumes that customers will take any price advantage that appears to them (i.e., customers are perfectly rationale). As Ms. Thomas indicated in response to cross-examination:

> Q. [T]he assumption that the unconstrained and the constrained model makes [*sic*] is that the customer is essentially economically rational, correct?
> A. Yes. It assumes that the customer would make economically rational decisions, yes.
> Q. And as Dr. LaCasse indicated this morning, the assumption of the model is if there's a 1 cent a meagawatt difference, the customer will react to that, correct?
> A. Yes.[97]

The assumption of customer "rationality," however, conforms neither to realities of customer loyalty, lack of CRES interest in some customers, restrictions on the ability of some customer groups to move at all, or the transaction costs noted previously.[98] Indeed, Dr. LaCasse noted that some customers will not switch when it is advantageous for them to do so.[99]

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[96] IEU-Ohio Remand Ex. 1 at 19-20; IEU-Ohio Remand Ex. 2 at 14.

[97] Tr. Vol. II at 273. The constrained model attempts to mitigate some of the irrationality implied by the unconstrained model by looking at the price advantage to customers over the life of the ESP. *Id.*; Vol. II at 275-76. The method by which this is modeled, however, is not particularly clear. Tr. Vol. V at 847-52.

[98] OCC Remand Ex. 1 at 20; IEU-Ohio Remand Ex. 2 at 11-14.

[99] Cos. Remand Ex. 3 at 14. The Companies seem to suggest that these concerns are not important when they claim that they have no idea of what customers are thinking when they make decisions about choosing an electric provider. Of course, it would not make any difference in their calculation of the option price since none of those behavioral factors is included as an adjustment to the formula. Tr. Vol. V at 858-59.

- The formula assumes that volatility is constant. Price volatility, however, is not demonstrated to be constant and is more volatile in some periods than in others.[100]
- The formula assumes that the strike price is constant. The strike price (the SSO rate), however, is not constant. In practice, it has generally increased over the term of the SSO.[101] As Ms. Thomas indicated, the SSO rate is subject to several riders that are regularly reconciled, resulting in "some movement of various riders" and thus the price of the SSO.[102]
- As used in the formula, the returns (or changes) in market price must be lognormally distributed to properly use the formula.[103] The Companies used wholesale PJM single swap prices to determine the daily return,[104] but these prices may not be lognormally distributed.[105] In any event, retail prices (not PJM wholesale prices) are the proper measure, and "there is simply no basis to conclude that the distribution of retail price 'returns' is lognormally distributed."[106]
- The formula is based on a European option which by definition has a fixed expiration date and may not be exercised prior to that date. Because a European option can be exercised only at the end of the term of the option, the

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[100] IEU-Ohio Remand Ex. 1 at 21.

[101] *Id.* at 22; OCC Remand Ex. 1 at 22.

[102] Tr. Vol. V at 862-64.

[103] IEU-Ohio Remand Ex. 1 at 22-23.

[104] OCC Remand Ex. 1 at 29.

[105] IEU-Ohio Remand Ex. 1 at 23-24

[106] *Id.* at 24.

Companies' formula for calculating the option bears no relationship to the decisions customers can make throughout the ESP. The constrained formula based on a series of European options and offered by the Companies as a test of the unconstrained model suffers from the same problem.[107]

Thus, there are at least five ways that the assumptions for proper calculation of the formula are violated.

Additionally, at least one of the inputs is not correct. The Companies calculated a 33.3% value for volatility of market prices.[108] The value for volatility was calculated using historic PJM energy prices, one component of the competitive benchmark price used as the market price input to the formula.[109] The volatility of the competitive benchmark price, however, would have been lower than that of the PJM energy prices because the benchmark price contains elements that have little or no volatility, thus buffering the effects of the volatility in the PJM energy prices.[110]

That the results of the formula are wrong, however, is based on more than just bad assumptions and faulty inputs. More fundamentally, the Black-Scholes formula was not designed for the task for which the Companies have used it. As Dr. Lesser stated, "[T]he Black model calculates the initial market value of an option. ... However, nothing in the Black model is intended to estimate the cost of the risk to the seller of an option (AEP Ohio) of providing this option. The Black model simply is not designed to estimate

[107] *Id.* at 24-25.

[108] Cos. Remand Ex. 4, LJT-3.

[109] IEU-Ohio Remand Ex. 1 at 26; OCC Remand Ex. 1 at 28-29.

[110] IEU-Ohio Remand Ex. 1 at 27-29; OCC Remand Ex. 1 at 28-30. The Commission Staff witness identified the calculated value of the volatility as a problem as well. Staff Remand Ex. 1 at 3.

the potential risk assumed by the seller of an option, as this risk is dependent on factors outside of the Black model, such as the actual out of pocket cost to AEP Ohio of providing energy to returning customers and AEP Ohio's potential hedging of this risk through other transactions."[111] Thus, the second proposition supporting the use of the valuation to set the POLR charge was demonstrated to be incorrect.

C. The Results of the Formula Are Unverified

Despite the apparent mismatch of the formula to the task the Companies used the formula for, the Companies nonetheless argued that the results generated by the formula were "fair and reasonable."[112] The Companies may wrongly point to three lines of testimony to support this claim. The first directly tied to Ms. Thomas's testimony was a comparison of the results of the constrained formula with the unconstrained formula using the Black-Scholes valuation formula.[113] The constrained version, however, contains most if not all of the problems in the unmodified version.[114] Comparing the results of the wrong measurement with the results of a similarly designed measurement simply makes no sense; if wrong, the results of the former will not be proved right simply by repeating the mistake.

The second implied line of argument was a presentation of "premiums" associated with the default service auctions in other states,[115] but the premiums'

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[111] IEU-Ohio Remand Ex. 1 at 25.

[112] Cos. Remand Ex. 4 at 16

[113] *Id.*

[114] OCC Remand Ex. 1 at 25.

[115] In direct testimony, the Companies never specifically indicate why they provided the testimony regarding other auction results. Dr. LaCasse provides a factual summary of various studies that demonstrate some "premium" included in auction prices ranging from 7 to 25%. Cos. Remand Ex. 3 at

relevance to the reasonableness of the POLR charge is doubtful. The premiums were described as adjustments to bids for a variety of risks including the risk of incurring costs for returning customers that the bidders were assuming.[116] Thus, the premiums encompass the POLR obligation of the bidders but also much more, and any comparison would not be "apples to apples." Moreover, the attempt to compare the premiums to the POLR charge would be difficult, if not impossible, given that the witness presenting the data was not be able to address any switching restrictions that might have affected the auctions, that the utilities reviewed in one of the studies had been required to spin off their generation facilities, and that in one instance (the Illinois staff report concerning Commonwealth Edison and Ameren) the authors of the report specifically cautioned that the authors took no position regarding the reasonableness of the risk premiums.[117] Thus, the implied comparison between the results of the various auctions and the Companies' formula-driven POLR charge was pointless.

The third suggestion that the Black-Scholes model might provide an estimated "cost" as defined by the Companies was Dr. LaCasse's Monte Carlo simulation. According to Dr. LaCasse, the reason for offering the simulation was to address the statement by Dr. Lesser "that an empirical Monte Carlo model should be used instead p.22 lines 12-14 in Lesser Direct [*sic*] implying that such an analysis would yield different results."[118] It is important to note that Dr. Lesser's testimony did not endorse

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18-20. Ms. Thomas claims that the analysis she performed is supported by Drs. Makhija and LaCasse. Cos. Remand Ex. 4 at 16. She also testified that the proposed POLR charge ranged from 3.8 to 7.3% of the SSO generation rates. Cos. Remand Ex. 4 at 6.

[116] Cos. Remand Ex. 3 at 19.

[117] Tr. Vol. II at 204-11.

[118] Cos. Remand Ex. 5 at 7.

any option pricing methodology to calculate the Companies' alleged POLR risk; in fact, he stated exactly the opposite.[119] The portion of Dr. Lesser's testimony identified by Dr. LaCasse specifically addressed a methodological error inherent in applying the Companies' formula to data for which the formula was not designed to handle. Dr. Lesser noted that the market price and the SSO price were correlated because of the effects of fuel prices on both; due to the correlation the use of the Black and Black-Scholes forumlas was improper. Dr. Lesser then noted that an option could be calculated using other alternatives such as a Monte Carlo method so as to recognize the option's value under multiple price paths.[120] Obviously, these comments did not suggest explicitly or implicitly that the Companies' cost to provide service could be modeled as an option.

Other concerns, however, suggest that the Monte Carlo simulation does not support the use of the formula to set the POLR charge. As with the Black-Scholes formula, it does not measure the cost to stand ready to serve returning customers. As Dr. LaCasse's testimony explained, the model identifies two "costs" incurred by the Companies. First, "[t]he model calculates the cost to AEP Ohio as the difference between the ESP price and the prevailing retail price (when that price is lower)" for leaving customers.[121] Second, "[t]he model calculates the cost to AEP Ohio as the difference between the now higher retail price and the ESP price" when a customer returns.[122] As previously noted, the first calculation is the lost revenues associated with

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[119] IEU-Ohio Remand Ex. 1 at 4-5.
[120] *Id.* at 22.

[121] Cos. Remand Ex. 5 at 9.

[122] *Id.*

customers migrating to a CRES provider. It is not a cost to the Companies. Moreover, there is no way to determine the effect of lost revenues on the resulting "cost" since the results of the calculation of the migration revenue loss embedded in the results was unknown.[123] The second calculation is at least an attempt to identify a cost the Companies might incur for securing the resources needed to serve a returning customer class. The modeling, however, is "fairly myopic" (regarding both the decision to leave and the decision to stay) in that the customers make decisions without any assumptions regarding longer term changes in price.[124] As described, the model also does not take into account any activity that the Companies may undertake to mitigate reduced profits.[125]

Apart from the fact that the simulation is not measuring the right thing, there was not a demonstration that it was measuring correctly. In this regard, Dr. LaCasse offered that the simulation was different from the Black-Scholes model, "but conceptually [one] should get to the same result in that in both cases the models rely on the expected difference between the SSO price now and the prevailing market price as it may change."[126] Yet, the results summarized by Dr. LaCasse are 17 to 29% lower than the results from the Companies' constrained formula.[127] The Companies made no attempt to demonstrate that this result is good, bad, or indifferent. Moreover, there was no

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[123] Tr. Vol. V at 690.

[124] *Id.* at 690-92.

[125] The record demonstrated that the Companies are supported by AEP Service Corp. in this regard. IEU-Ohio Remand Ex. 6 at 13.

[126] Tr. Vol. V at 693.

[127] Cos. Remand Ex. 5, CL-3.

attempt to demonstrate that the model has been verified or tested in any way,[128] and the model was not verified against the actual customer switching for 2009.[129] Given the minimal customer switching that took place in 2009 and 2010,[130] the usefulness of the Monte Carlo simulation is negligible.

D. The Companies Have Failed to Demonstrate that the POLR Charge is Either Cost-Based or Supported by an Alternative Non-Cost-Based Rationale

The remand afforded the Companies a second chance to advance some basis for recovering a charge for standing ready to serve customers who return to SSO service. Certainly, they have not demonstrated any out-of-pocket costs. Instead of identifying costs or offering a non-cost-based rationale, the Companies have sought to demonstrate that the Black-Scholes formula as originally proposed results in a proper estimate of their costs of the risk of being the POLR provider. Ignoring the Supreme Court's definition of the POLR obligation, the Court's admonition that value to customers is not the same thing as cost to the Companies, the formula's nonsensical assumptions and results, and their own experience over the initial two and a half years of the ESP in which they have not documented a dollar of cost incurred as a result of serving or standing ready to serve a returning customer, the Companies now ask to continue to collect the POLR charge on the original terms. That result, however, is unreasonable and unlawful and should be rejected by the Commission.

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[128] Dr. LaCasse did not participate in the programming and first reviewed it on July 22, 2011, three days before testimony was submitted. She did not participate in the "debugging process." Tr. Vol. V at 694-98.

[129] *Id.* at 700.

[130] IEU-Ohio Remand Ex. 6 at 31 (3% load loss by CSP in 2010; OPCo load loss negligible); Cos.Remand Ex. 4, LJT-2 (CSP load served by CRES less than 2% in January 2010).

VII. THE SCOPE OF THE REMEDIES INCLUDES REQUIRING NEW TARIFFS, REFUNDS OR CREDITS AND ADJUSTMENTS FOR FLOW-THROUGH EFFECTS

If the Commission correctly finds that the Companies have failed to justify their proposed POLR charge, the Commission should order several remedies.

First, the Commission should direct the Companies to file tariffs to conform to the Court's decision and the Commission determination that the environmental carrying costs embedded in the non-fuel-related generation charge POLR charges be removed.[131]

Second, the Companies should be directed to refund or credit amounts collected subject to refund to customers with appropriate interest for the time value of the customers' money.[132]

Third, the Commission should address the effects of the remand and its decision on the amounts of the deferrals currently accumulating as a result of the bill limiters in the current ESP. Total amounts that must be addressed are $253.3 million and $132.4 million related to POLR charges for CSP and OPCo, respectively, and $62.8 million and $203 million related to 2001-2008 environmental carrying costs for CSP and OPCo, respectively.[133] These amounts will also need to be adjusted so that no interest on these amounts remains in any deferral revenues to be collected by the Companies. The scope of the Supreme Court's decision, however, is not limited to the deferrals. As discussed below, the current ESP serves as the basis for the Companies' pending application and the current ESP may continue (subject to adjustment) if the Companies

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[131] IEU-Ohio Remand Ex. 3 at 9.

[132] *Id.*

[133] *Id.* at 11 & 14.

withdraw their current ESP application or if the Commission dismisses the current application for noncompliance with statutory or regulatory requirements.

The rationale for adjusting deferrals for flow-through effects of the remanded issues is straight-forward. Prior to the Commission's May 4, 2011 Entry, OPCo estimated that the accumulated deferred revenue eligible for future collection would be $643 million by late 2011. However, OPCo's estimate of deferred revenue eligible for future collection is a residual calculation. It is the difference between the revenue collected during the ESP period subject to the bill increase limitations and the revenue increases that would have otherwise occurred without such limitations. OPCo's estimate of deferred revenue is significantly excessive because embedded in the math that produced OPCo's estimate is an allowance for revenues which cannot be lawfully recognized for purposes of establishing rates and charges.

The 2009 ESP Opinion and Order authorized OPCo and CSP to, individually, collect a total revenue amount, part of which was collectable during the term of the current ESP and part of which was deferred for collection in the future. The portion of such total authorized revenue deferred for future collection (through a phase-in mechanism) is a subset of the total revenue collection that the Commission may lawfully authorize through the exercise of its authority in Section 4928.143, Revised Code. The amount of the revenue deferred for future collection through a phase-in mechanism must also be "just and reasonable."[134]

In keeping with this "just and reasonable" standard, the Commission must, in compliance with the Supreme Court's decision, reduce the total authorized revenue in the current ESP Opinion and Order by the amount of revenue that the Commission

[134] Section 4928.144, Revised Code.

previously included in this total. Because the portion of the total authorized revenue that was deferred for collection is defined by a residual calculation, the deferred revenues must be reduced by an amount equal to that portion of the revenues authorized by the Commission in its ESP order that the Supreme Court has determined are unlawful.

If OPCo or CSP is permitted to collect deferred revenues calculated as though the revenue amounts the Commission authorized in the current ESP Opinion and Order were lawful, the requirement that the phase-in rates are just and reasonable cannot be satisfied.

Thus, Section 4928.144, Revised Code, and the recent Supreme Court decision require a restatement of the amount of deferred revenue eligible for future collection to properly reflect the value associated with the Companies' unlawfully authorized revenue increases plus an appropriate allowance for carrying charges. Unless the deferred revenue balance is restated and substantially lowered, the amount of revenue increase which the Supreme Court has held to be unlawful will be embedded in the amount of revenue deferred for future collection. Unless the deferred revenue balance is restated, the injustice of the unlawfully authorized increases will be perpetuated for seven years through a phase-in rider that ignores reality and the law.

Commission action regarding the effect of the remand, however, is not limited to the deferred balances OPCo will be seeking to recover. The second illustrative area concerns the amount of revenue which OPCo and CSP may lawfully collect through mechanisms that allow, as permitted by the Commission, recovery of "delta revenue." Delta revenue is the revenue difference between rates and charges in a reasonable arrangement and the revenue produced by rates and charges in an otherwise applicable tariff schedule. For example, the Commission has authorized delta revenue recovery as a result of a reasonable arrangement for Ormet Primary Aluminum Corporation ("Ormet").[135] The unlawful revenue increases identified by the Supreme Court are embedded in the revenue produced by the otherwise applicable rate(s) for Ormet. Thus, the amount of delta revenue eligible for collection as a result of the Ormet reasonable arrangement has been unlawfully overstated in the past and will be unlawfully overstated going forward unless the unlawfully authorized revenue is removed from the rates and charges in the otherwise applicable tariff schedule(s).

Similarly, the operation of the Universal Service Fund or "USF" generates revenue recovery that is overstated. This fund provides bill payment assistance to income eligible residential consumers, and other consumers pay USF charges to make OPCo and CSP whole for the difference in the amount collected from income eligible customers and the amount such customers would have paid on the otherwise applicable rate. As in the case of the delta revenue illustration above, the unlawfully authorized revenue caused the otherwise applicable rate to be higher than the lawful rate and, in turn, increased the magnitude of the USF charges that have been paid and will continue to be paid until the unlawfully authorized revenue and all of its implications are stripped from all rates and charges (including riders).

The third illustrative area involves the effect of the unlawfully authorized revenue increases and the operation of the retrospective significantly excessive earnings test

[135] *In the Matter of the Application of Ormet Primary Alum. Corp. for Approval of a Unique Arrangement with Ohio Power Co. and Columbus Southern Power Co.*, Case No. 09-119-EL-AEC, Opinion and Order (July 15, 2009).

("SEET").[136] Revenues unlawfully authorized and collected must, for ratemaking and SEET purposes, be classified, dollar-for-dollar, as revenues the utility actually received as a result of the ESP (after taxes, the revenues become net income on the Companies' income statements). If the Commission properly jurisdictionalizes the income statement and the balance sheet values that drive the SEET determination (as IEU-Ohio has previously and unsuccessfully – to this point – argued is required by Ohio law), the SEET can provide the Commission with an opportunity to rectify, at least in part, the effect of unlawfully authorized and collected revenue.

The fourth illustrative area concerns the relationship between the Companies' current ESPs (with the embedded unlawfully authorized revenue therein) and the plan filed in the 2011 ESP Application. The revenue produced by the current ESPs (including the embedded unlawfully authorized revenue) provides the revenue foundation for the 2011 ESP.[137] This foundation is excessive by the unlawfully authorized amount of revenue and is itself unlawful to that extent.

In summary, the Supreme Court has determined that the Commission authorized CSP and OPCo to unlawfully bill and collect increased revenue. More than two years have passed since the Companies implemented the unlawful authority to increase revenue, rates, and charges over the objections of every consumer group that participated in these proceedings. Hundreds of millions of dollars of consumers' wealth have already been unlawfully transferred to the Companies, and this unlawful wealth

[136] Section 4928.143(F), Revised Code.

[137] *In the Matter of the Application of Columbus Southern Power Company and Ohio Power Company for Authority to Establish a Standard Service Offer Pursuant to 4928.143, Ohio Rev. Code, in the Form of an Electric Security Plan*, Case No. 11-346-EL-SSO, et al., Testimony of David Roush, Exhibit DMR-2 (January 27, 2011) ("*2011 ESP Application*").

transfer will be perpetuated in numerous ways until the Commission strips away all the effects of the unlawfully authorized revenue increases.

VIII. THE COMPANIES FAIL TO ADDRESS THE PROPER TREATMENT OF THE PHASE-IN REVENUES

In what can only be termed a smoke screen, the Companies' rebuttal testimony argued that the Companies were properly booking the deferrals as deferred expenses pursuant to Generally Accepted Accounting Principles ("GAAP") as established by the Financial Accounting Standards Board ("FASB"). The short answer to this assertion is that it is irrelevant. As the Companies' witness Mr. Mitchell noted on cross-examination, it is the Commission's orders that determine what is properly deferred for accounting purposes, and should the Commission determine that these amounts held as deferrals are not properly converted into phase-in charges, the Companies' accounts will have to be properly charged with expenses to recognize that there is no longer a reasonable expectation of recovery.[138] More importantly, this Commission has recognized its role to supervise what is recovered from customers regardless of the accounting treatment the Companies have used to state the values of assets. In the 1991 CSP rate case, for example, the Commission applied the terms of the Zimmer Restatement Case settlement to reduce a booked allowance for funds used during construction ("AFUDC") to restate the rate base for the Zimmer plant because the amounts booked were

[138] Tr. Vol. V at 766.

inconsistent with proper regulatory accounting and the terms of the settlement.[139] Thus, regulatory law drives accounting decisions, and not the other way around.

The Commission itself recognized in the Opinion and Order that the deferrals booked by the Companies were not sacrosanct. In setting the bill limiters, the Commission held: "[W]e exercise our authority pursuant to Section 4928.144, Revised Code, and find that the Companies should phase-in any *authorized increases* so as not to exceed, on a total bill basis, an increase of 7 percent for CSP and 8 percent for OP for 2009, an increase of 6 percent for CSP and 7 percent for OP for 2010, and an increase of 6 percent for CSP and 8 percent for OP for 2011 are more appropriate levels."[140] The Commission continued that "[a]ny amount over the *allowable total bill increase* percentage levels will be deferred."[141] The resulting surcharge was to be based on the balance remaining at the end of 2011.[142] The Companies themselves recognize that the amounts that may be collected through the phase-in rider are subject to continuing review through FAC proceedings that are ongoing.

When the Supreme Court subsequently found the POLR charge and the environmental investment revenues to be illegal, the Commission was required to determine before collections started how much if any of the deferrals were properly collectable. Just as the Companies recognized when they filed tariffs in compliance

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[139] *In the Matter of the Application of Columbus Southern Power Co. for Authority to Amend its Filed Tariffs to Increase the Rates and Charges for Electric Service*, Case No. 91-418-EL-AIR, Opinion and Order at 15-18 (May 12, 1992).

[140] Opinion and Order at 22 (March 18, 2009) (emphasis added).

[141] *Id.*

[142] *Id.* at 22-23. The Commission recognized that the deferrals could be adjusted throughout the ESP term if the FAC expense in a given period was less than the maximum phase-in FAC rate. *Id.* at 22.

with the May 4, 2011 Commission Entry, the effect of the remand is to require an evaluation of what is allowed to be recovered. Part of the process includes recognition of any changes that result from the FAC reviews that are on-going. Another part is the recognition that the deferrals on the Companies' books are improperly inflated because the POLR charges and incremental environmental investments were included in the revenue calculation subject to the bill limiters when they should not have been.

IX. CONCLUSION

As outlined above, IEU-Ohio urges the Commission to reject the Companies' proposals to charge customers for environmental investments not demonstrated to fall within the terms of Section 4928.143(B)(2), Revised Code, and for non-existent costs to be ready to serve customers who return to SSO service. The Companies have made no attempt to demonstrate that the 2001-2008 environmental investments are recoverable under any of the listed items in Section 4928.143(B)(2), Revised Code. Ignoring the Supreme Court's repeated admonition to demonstrate that they incur a cost for standing ready to serve returning customers, they instead have attempted to resuscitate a POLR charge on "cost" grounds already found without legal merit. If the Commission properly finds that these charges are not justified, then the Commission should also undertake to suspend further collection of the illegal rates, refund amounts collected subject to refund, and begin unwinding the accounting that would otherwise continue the illegal transfer of customer funds to the Companies.

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Certificate Of Service

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