BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the 2010 Annual Filing of Columbus Southern Power Company and Ohio Power Company Required by Rule 4901:1-35-10, Ohio Administrative Code.	)))))	Case No. 11-4571-EL-UNC Case No. 11-4572-EL-UNC

INITIAL BRIEF OF INDUSTRIAL ENERGY USERS-OHIO

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I. INTRODUCTION

Amended Substitute Senate Bill 221 ("SB 221") provided two checks on the revenue that an electric distribution utility ("EDU") may collect and retain under an electric security plan ("ESP"). First, the Public Utilities Commission of Ohio ("Commission") must determine that the ESP is "more favorable in the aggregate as compared to the expected results that would otherwise apply" under a market rate offer ("MRO") before the Commission may approve an application for an ESP.[1] Second, the Commission must determine annually if an approved ESP produces an earned return on common equity of the EDU that is significantly in excess of the return on common equity by other publicly traded companies, including utilities, that face comparable business and financial risk.[2] To the extent that an EDU is found to have significantly excessive earnings, the Commission is directed to order the significantly excessive

[1] Section 4928.143(C)(1), Revised Code.

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

earnings returned to customers.[3] This annual earnings review is the Significantly Excessive Earnings Test ("SEET"), set out in Section 4928.143(F), Revised Code, and requires the Commission to focus on only the ESP-related earned returns on common equity of the EDU.

Despite the statutory requirements, the Ohio Power Company and Columbus Southern Power Company ("OP", "CSP", or "Companies") have provided the Commission with Applications[4] for their 2010 SEET review seeking a finding that neither company has significantly excessive earnings as a result of their ESPs based on total company data.[5] Based on this total company data, the Commission cannot make any determination on whether the Companies have "passed the SEET." The failure of the Companies' Applications to comply with the statutory requirements, thus, obliges the Commission to dismiss the Applications and to direct the Companies to prepare and file the information that is necessary for the Commission to properly apply the SEET.

II. ARGUMENT

A. The Commission Should Dismiss the Companies' Applications and Direct the Companies to Re-file Applications that Comply with the Statutory Requirements

Section 4928.143(F), Revised Code, provides:

> **With regard to the provisions that are included in an electric security plan** under this section, the commission **shall** consider, following **the end**

[3] *Id.*

[4] The Applications consist of a cover letter and testimony from three supporting witnesses filed on July 29, 2011 and later updated.

[5] The data the Companies supplied to the Commission, and on which they base their SEET calculations, includes earnings and equity attributable to areas outside of their ESP's and outside of the Commission's jurisdiction, *i.e.* wholesale sales for resale transactions including off-system sales. *See* Argument at 5.

> **of each annual period of the plan**, if any such adjustments resulted in excessive earnings as measured by whether the **earned return on common equity of the electric distribution utility** is significantly in excess of the return on common equity that was earned during the same period by publicly traded companies, including utilities, that face comparable business and financial risk, with such adjustments for capital structure as may be appropriate. Consideration also shall be given to the capital requirements of future committed investments in this state. The burden of proof for demonstrating that significantly excessive earnings did not occur shall be on the **electric distribution utility**. If the commission finds that such adjustments, in the aggregate, did result in significantly excessive earnings, it shall require the **electric distribution utility** to return to consumers the amount of the excess by prospective adjustments; provided that, upon making such prospective adjustments, the electric distribution utility shall have the right to terminate the plan and immediately file an application pursuant to section 4928.142 of the Revised Code. Upon termination of a plan under this division, rates shall be set on the same basis as specified in division (C)(2)(b) of this section, and the commission shall permit the continued deferral and phase-in of any amounts that occurred prior to that termination and the recovery of those amounts as contemplated under that electric security plan. In making its determination of significantly excessive earnings under this division, **the commission shall not consider, directly or indirectly, the revenue, expenses, or earnings of any affiliate or parent company**.

(Emphasis added.)

Section 4928.143(F), Revised Code, contains words that are defined by Ohio law and, as stated in Section 4928.01, Revised Code, these definitions control for purposes of constructing and applying the SEET.

Section 4928.01, Revised Code, defines "electric distribution utility" as an "electric utility" that supplies retail electric distribution service and defines an "electric utility" as an "electric light company," the entity that has an Ohio certified territory and also provides retail service in Ohio.

The definitions in Section 4928.01, Revised Code, apply to Section 4928.143(F), Revised Code, and these definitions control the scope of the SEET. Based on these definitions and the plain meaning of Section 4928.143(F), Revised Code, the SEET must be applied to measure the earned return on common equity of the EDU's retail ESP service which is the service that is subject to the Commission's jurisdiction.[6] This is the only service that can be covered by a rate plan that the Commission is empowered to approve under Section 4928.143, Revised Code. Therefore, the SEET mandated by Section 4928.143(F), Revised Code, requires the Commission to design and apply the SEET to identify the EDU's earned return on common equity as that earned return is measured from a retail service rate plan approved by the Commission under Section 4928.143, Revised Code. The EDU's ESP is the only matter within the scope of the SEET.

Four provisions of Section 4928.143(F), Revised Code, moreover, define and confirm that the focus of the SEET is on the EDU's ESP-related earned return on common equity. First, the review of earned return on common equity is limited to "the provisions that are included in an electric security plan under this section." Second, this limit to a review of the ESP earned return on common equity is re-emphasized later in the division as it directs the Commission to determine if "any such adjustments [from the

[6] The legal fact that the Commission's authority is limited to the scope of its jurisdiction is and has been fundamental to defining the Commission's authority. This subject matter jurisdiction limitation grows from the separation of powers achieved by the United States Constitution and authority that has been placed in Congress as compared to the authority reserved to the various states. Indeed, utility applications for rate increases have historically been filed with explicit reference to the service that is subject to the Commission's jurisdiction. *In the Matter of the Application of The Toledo Edison Company for Authority to Amend and Increase Certain of its Rates and Charges for Electric Service,* Case Nos. 95-299-EL-AIR, *et al.,* Opinion and Order (Apr. 11, 1996). Section 4928.39, Revised Code, required the Commission to jurisdictionalize any transition cost allowance that the Commission authorized EDUs to collect in conjunction with Ohio's approach to restructuring its electric laws and regulations. *In the Matter of the Application of FirstEnergy Corp. on Behalf of Ohio Edison Company, The Cleveland Electric Illuminating Company, and The Toledo Edison Company for Approval of Their Transition Plans and for Authorization to Collect Transition Revenues*, Case Nos. 99-1212-EL-ETP, *et al.,* Opinion and Order at 31-36) (July 19, 2000). The notion that the Commission must apply the SEET to respect this fundamental legal principle is hardly new. But whether new or old, this principle must also be respected because this principle is an explicit requirement of Section 4928.143(F), Revised Code.

ESP] resulted in excessive earnings." Third, the division directs that the Commission shall order a return of any excess to customers if the Commission "finds that such adjustments, in the aggregate, ... result in significantly excessive earnings." Fourth, the section specifically excludes consideration of any parent or affiliate company in the application of the SEET.[7]

Two conclusions can be drawn from the language of Section 4928.143(F), Revised Code. First, the review is focused on EDUs, rather than an affiliated company, a parent company, or a fictional entity (*e.g.* AEP-Ohio is a commonly used designation to refer to both CSP and OP, but AEP-Ohio is not an EDU or a legal entity itself). Second, the scope of the SEET is the earned return on common equity from the ESP. These conclusions are the purposeful result of the General Assembly's effort to manage the risk of an ESP that is significantly and excessively unbalanced in favor of an EDU relative to its retail customers. More bluntly stated, there is no way for the SEET to protect consumers against the excesses of an ESP unless it is focused on the EDU's earned return on common equity from the ESP.

Despite the statutory requirements for applying the SEET, the Companies failed to present a case-in-chief that will permit the Commission to apply the SEET as required by Section 4928.143(F), Revised Code. The witnesses for the Companies confirmed that the EDUs are engaged in lines of business other than the provision of retail service under the ESP.[8] In addition to retail service, the Companies generated revenue from

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

[8] Tr. Vol. I at 15.

other sources,[9] including sales for resale that include Off-System Sales ("OSS") and wholesale transactions other than OSS[10] not regulated by the Commission.[11]

Despite the fact that each EDU generates net income from multiple lines of business, the Companies, nonetheless, presented their claim that their ESPs were not generating significantly excessive earnings based on total company data that failed to separate the retail ESP data from that of the EDUs' other lines of business. As Mr. Mitchell makes clear in his testimony, the only adjustments to net income made in the Applications, other than the OSS-related ones, were for nonrecurring items due to the Companies' organizational restructuring, an adjustment due to changes in federal law, and an adjustment for the 2009 SEET findings.[12] The Companies did not make any attempt to "jurisdictionalize" their total Company data that they presented in their Applications.

A comparison of the starting points for the calculation of each Company's calculation of earned return with the Federal Energy Regulatory Commission ("FERC") Form 1 filings[13] confirms that Mr. Mitchell used total company data to derive the earned return on common equity. In his revised exhibit TEM-1,[14] the average common equity

[9] *Id.* at 59-67.

[10] *Id.* at 15.

[11] *Id.* at 16.

[12] Cos. Ex. 2 at 3-4; Tr. Vol. I at 64.

[13] Mr. Mitchell indicated that he based his calculations of total company return on equity on the Companies' SEC 10-K filing, but that the financial information in the 10-K is the same as what is presented in the FERC Form 1. Tr. V. I at 64.

[14] Cos. Ex. 2, TEM-1.

for CSP ties to page 112, line 16, of the CSP FERC Form 1.[15] Similarly, the average common equity of OP ties to FERC Form 1, page 112, line 16, with adjustments removing the value of preferred stock (OP FERC Form 1, page 112, line 3) and the value of paid-in capital associated with the merger of OP with JMG Funding LP (OP FERC Form 1, page 253, line 27).[16] Mr. Mitchell's total company net income figures for CSP tie to page 117, line 78, of the CSP FERC Form 1, adjusted for a capital stock expense, CSP FERC Form 1, page 118, line 10.[17] For OP, his net income figure ties to page 117, line 78 of the OP FERC Form 1, adjusted for preferred stock dividends found on page 118, line 29, of the OP FERC Form 1.[18] Thus, each amount used as the starting point for the calculation of the earned return on common equity is based on total company numbers, rather than EDU ESP-specific numbers.

The Commission Staff ("Staff") witness and the Ohio Energy Group ("OEG") witness did not challenge the Companies' use of the total company data to determine the Companies' earned return on common equity. The Staff's witness, Mr. Buckley, did not address the Companies' determination of the numerator and denominator; rather, he accepted the Companies' calculation and focused his testimony on calculating the

[15] Cos Ex. 1C at 112, line 16.

[16] Cos Ex. 1B at 112, line 16 & line 3, & 253, line 27.

[17] Cos Ex. 1C at 117, line 78 & 118, line 10.

[18] Cos Ex. 1B at 117, line 78 & 118, line 29.

comparable group's earned return on common equity.[19] OEG's witness, Lane Kollen, also used the total company data to construct his analysis.[20]

Thus, the record does not contain any evidence that isolates each EDU's ESP-related earned return on common equity from the total company data. The Companies and OEG relied on total company data, and the Staff relied on the Companies' calculations. As none of the witnesses applied the SEET as set out in Section 4928.143(F), Revised Code, the Commission lacks the evidentiary support to determine if the Companies had an earned return on common equity that was significantly in excess of that of a comparable group of publicly traded companies.[21]

B. The Record Demonstrates the Need to Properly Isolate the Effects of the ESPs on the EDUs' Earned Return on Common Equity

The record in this SEET review also contains strong circumstantial evidence that a properly applied SEET would restore the type of customer/utility balance that is required by Chapter 4928, Revised Code.[22] Properly applying the SEET to both OP and CSP will provide information that is required to make sure that the customers of OP and CSP are not carrying too much responsibility for AEP's overall profit objectives in violation of Section 4928.143(F), Revised Code, and other state energy policy mandates.

[19] Staff Ex. 1 at 2

[20] Tr. Vol. 1 at 102.

[21] The motions to dismiss apply to both EDUs. There is no basis in the record for the Commission to conclude that either OP or CSP is not earning significantly excessive earnings.

[22] As Mr. Kollen anticipated in 2008 during the Companies' first ESP hearing, it was predictable that the Companies would be earning significantly excessive returns on common equity once the Commission approved their initial ESPs. Tr. Vol. I. at 101-02.

In its public statements to the investment community, American Electric Power Company, Inc. ("AEP") has demonstrated the degree to which Ohio retail customers are carrying the load for AEP's shareholders. For example, gross margin[23] data given to investors show that AEP's Ohio Companies (OP and CSP) provided a gross margin of $54.30/MWh in 2010.[24] This gross margin for OP and CSP was substantially higher than any other reported AEP operation.[25] Additionally, CSP and OP accounted for about 24.3% of total MWh sales, yet provided 34.8% of the total gross margin revenue from MWh sales.[26] The rates in Ohio are also the highest among the AEP-East operating companies[27] even though the costs of providing generation and transmission service are shared throughout the AEP-East system.[28]

Given the apparent burden on Ohio customers, state energy policy mandates that the Commission carefully and accurately apply the SEET so that the ESPs of the EDUs do not frustrate Ohio's competitiveness.[29] "[The Commission is] tasked, under Chapter 4928 of the Revised Code, with approving generation charges that are market-based and consistent with the state policy set forth in this chapter."[30] Specifically, the

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[23] "Gross margin" is defined as revenues less fuel, including chemicals, emissions allowances, and purchased power. Tr. Vol. 1 at 19.

[24] IEU-Ohio Ex. 1 at 11. See Attachment 1.

[25] *Id.*

[26] *Id.*

[27] IEU-Ohio Ex. 3.

[28] Cos. Ex. 1A at 11-12.

[29] Section 4928.02, Revised Code.

[30] *In the Matter of the Consolidated Duke Energy Ohio, Inc. Rate Stabilization Plan Remand and Rider Adjustment Cases*, Case Nos. 03-93-EL-ATA, *et al.*, Order on Remand at 36 (Oct. 24, 2007).

Commission is to "[f]acilitate the state's effectiveness in the global economy."[31] Businesses in Ohio compete with businesses in Indiana, Michigan, Kentucky, and West Virginia. If the retail customers of the Ohio EDUs are currently responsible for more than their fair share of the overall profitability of AEP, the Commission is required to take action because this undue burden on Ohio customers affects their ability to, among other things, compete in the global economy.

Applying the SEET to identify the net income available for common shareholders and the portion of OP's and CSP's equity capital directly assignable or allocable to the retail service provided by each EDU pursuant to the retail rate plan (making sure the SEET is applied to the retail jurisdiction subject to the Commission's jurisdiction) is required by law. Based on the evidence in this record, applying the SEET as written by the General Assembly may also help to identify and eliminate a significantly excessive burden that now rests on the backs of the retail customers of the Companies in ways that will permit the Commission to also discharge its duties under Section 4928.02, Revised Code.

C. The Companies' OSS Adjustment Is Fundamentally Flawed

Even if one were to accept that the Commission should consider the use of total company net income and common equity as a starting point for applying the SEET, the Companies have failed to make the necessary adjustments to remove non-ESP revenue and common equity to properly apply the test. As noted above, the net income in the Companies' calculations contains several lines of business that cannot be

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[31] Section 4928.02(N), Revised Code.

properly assigned to the ESP and are nonetheless left in the numerator. The denominator of the calculation of earned return on common equity similarly fails to be adjusted to reflect the common equity supporting the ESP. Moreover, in the Companies' attempt to comply with the Commission's prior directive to adjust the calculation for the effects of OSS, they do not adjust common equity to account for transmission plant supporting OSS.

As Mr. Hamrock testified, a physical sale of generation requires transmission plant for completion.[32] The Companies' adjustment to remove common equity supporting OSS from the denominator, however, separates the generation plant from total plant, divides that amount by total plant, and multiplies that fraction by average book equity to create an allocation of equity that "supports" OSS.[33] No transmission plant is assigned to the calculation.[34]

The failure to account for transmission plant in the calculation of the common equity (the denominator in the SEET) uniformly biases the application of the SEET in favor of the Companies. By adjusting common equity associated with only generation plant, the allocation of equity associated with OSS is by definition understated. This understatement translates into an overstatement of average common equity in the SEET. If the denominator is larger than it should be, the resulting earned return on common equity will be smaller. In effect, the Companies have taken advantage of a simple mathematical fact to bias the SEET in their favor.

[32] Tr. Vol. I at 16-17.

[33] Cos. Ex. 2, TEM-1 at 4.

[34] Tr. Vol. I at 72-73.

Additionally, the method by which the Companies attempted to adjust for OSS does not comport with accepted utility regulatory practice. As Mr. Kollen indicated, utility practice suggests the need either to properly apply a cost of service approach or to assign all costs to retail jurisdictional sales and then credit all wholesale revenue to offset those costs.[35] The Companies adopted neither approach.[36]

The prior discussion of the Companies' approach should not be deemed an endorsement of an attempt to "correct" the Companies' adjustment for OSS.[37] As Industrial Energy Users-Ohio ("IEU-Ohio") previously argued in the 2009 SEET case and by its motions to dismiss in these cases, the approach used by the Companies does not comport with the statutory requirements of the SEET. Rather, this discussion again highlights the need to perform the SEET correctly by accounting for the effects of the ESP on the earned return on common equity of the Companies.

D. The Companies Do Not Provide a Basis for Increasing the Threshold for the Determination of Significantly Excessive Earnings

In addition to providing a calculation that does not comply with the statutory requirements of the SEET, the Companies also encourage the Commission to increase the threshold for a finding of significantly excessive earnings. Through the testimony of Mr. Hamrock, the Companies point to several "additional factors" that the Commission

[35] OEG Ex. 1 at 9-10.

[36] *Id.* at 9

[37] The treatment of OSS is a part of the appeal IEU-Ohio has taken from the 2009 SEET Order. *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 4902:1-25-10, Ohio Administrative Code*, Supreme Ct. Case No. 2011-0751, Brief at 25-31 (Aug. 8, 2011).

should consider in determining if the Companies' earned return is significantly excessive.[38] Among those factors identified by the Companies are "industry leadership," business and regulatory risk, service reliability risk, and customer migration risk.[39] The factors to which the Companies point, however, do not provide a basis to adjust the SEET threshold.

The Companies initially suggest that industry leadership in several areas including transmission, renewable energy and gridSMART, and new generation resources requires a higher SEET threshold. The Companies, however, failed to note that their transmission leadership is not a matter for consideration in the return related to the ESP, as those activities are regulated by the FERC.[40] Their "leadership" regarding environmental compliance is compensated by recovery mechanisms based on substantial carrying charges.[41] Further, any compliance costs associated with renewable energy credits are recovered through the Fuel Adjustment Clause that the Commission authorized the Companies to collect in their ESPs.[42] Thus, the Companies do not justify some additional "protection" from a finding of significantly excessive earnings because of their leadership relates to activities that are either non-jurisdictional or for which they are well-compensated.

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[38] Cos. Ex. 1 at 13.

[39] Cos. Ex. 1 at 12-20.

[40] Tr. Vol. I at 29.

[41] *Id.* at 30. See *In the Matter of the Application of Columbus Southern Power Company for Approval of an 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.*, Opinion and Order at 18, 24-28, & 34 (Mar. 18, 2009) ("*ESP I*").

[42] *ESP I* at 18.

The Companies also did not face any exposure to the cost of environmental compliance during the 2010 review period.[43] Although the Companies suggest that they suffered "regulatory lag" related to their environmental investment, they were authorized to collect revenue on past investment through non-FAC generation rates and on post-2009 investment through a rider that increased annually with whatever investment the Companies made during the ESP.[44]

The Companies' concern about the risk of customer migration similarly is not a basis for adjusting the threshold for determining whether earnings are significantly excessive. Neither CSP nor OP experienced any significant customer migration in 2010; only CSP reported any losses in gross margins, which were minor, and expected to recover some of that loss through OSS.[45] More than offsetting any loss in gross margins from migration, the Companies were authorized to recover, through the now-illegal Provider of Last Resort ("POLR") charge, approximately $153 million annually.[46]

Additionally, the Companies point to the risk associated with deferrals used to maintain rates at lower levels.[47] While there is admittedly some lag associated with any deferral, the resulting charges created by the ESP are non-bypassable[48] and are loaded

[43] Cos. Ex. 1 at 16-18.

[44] *ESP I*, Opinion and Order at 24-28; Tr. Vol. I at 32-33.

[45] CSP reported that it saw a reduction in gross margin of $16 million due to customer migration, but expected to recover some of that gross margin through off-system sales. Tr. Vol. I at 34. Migration from OP was deemed not significant. *Id.* at 35.

[46] Tr. Vol. I at 33.

[47] Cos. Ex. 1 at 18.

[48] Section 4928.144, Revised Code.

with a heavy carrying cost.[49] Further, the recent Commission decision approving a rider to recover the deferral amounts permitted the Companies to calculate the deferral amounts without an adjustment for accumulated deferred income taxes, further inflating the deferral recovery for amounts the Companies did not finance.[50] There is no basis for giving the Companies further protection by adjusting the threshold of the SEET.

E. Requested Relief

Based on the failure of the Companies to present the information they are required to provide to allow the Commission to properly apply the SEET, the Commission should grant IEU-Ohio's motions to dismiss made prior to hearing and at the conclusion of the Companies' case-in-chief. The Companies did not provide the Commission with any demonstration that supports a finding that the Companies' earned returns on common equity are not significantly excessive under their ESPs. The failure to bring forward the appropriate evidence makes it impossible for the Commission to make a finding required by Section 4928.143(F), Revised Code.

The Commission, however, should go beyond merely directing the Companies to re-file. An order of dismissal should also outline what the Companies should file to properly initiate the required annual review. To that end, the Commission should recognize that more is needed from the Companies than the currently mandated 10-K and FERC Form 1. Additionally, the Commission should direct the Companies to file as

[49] *ESP I*, Opinion and Order at 23 (carrying charge on deferrals is based on weighted average cost of capital).

[50] *In the Matter of the Application of Columbus Southern Power Company for Approval of a Mechanism to Recover Deferred Fuel Costs Ordered Under Section 4928.144, Ohio Revised Code*, Case Nos. 11-4920-EL-RDR *et al.*, Opinion and Order at 58 (Dec. 14, 2011).

part of their application a detailed study that properly jurisdictionalizes the earned return on common equity for each EDU's ESP. As Mr. Kollen testified, such a study would isolate the revenue and expenses that were the result of the ESP and make a further adjustment to the common equity to determine the earned return on common equity.[51] Until the Companies satisfy their legal obligation to provide this information to the Commission, any finding for either EDU that the Commission makes will fail to comply with the statutory requirements of the SEET.

III. CONCLUSION

For the reasons explained herein, IEU-Ohio respectfully urges the Commission to dismiss the Companies' Applications without prejudice and to direct the Companies to file new applications providing the information required by Section 4928.143(F), Revised Code, in a form by which the Commission can perform the SEET. Neither CSP nor OP has met the burden to show that it did not experience significantly excessive earnings as a result of its individual ESP during 2010. In other words, the Commission must direct CSP and OP to start over.

[51] OEG Ex. 1 at 9.

Respectfully submitted.

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CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing *Initial Brief of Industrial Energy Users-Ohio* was served upon the following parties of record this 31st day of January, 2012, *via* electronic transmission, hand-delivery or first class U.S. mail, postage prepaid.

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ON BEHALF OF THE PUBLIC UTILITIES COMMISSION OF OHIO

Attachment 1

IEU-Ohio Ex. 1 at 11

		Performance Driver	2010 Actual ($ millions)	2010 Actual EPS
	UTILITY OPERATIONS:			
	Gross Margin:			
1	East Regulated Integrated Utilities	18,575 GWh @ $ 42.2 /MWhr =	784	
2	Ohio Companies	12,584 GWh @ $ 54.3 /MWhr =	683	
3	West Regulated Integrated Utilities	9,790 GWh @ $ 27.7 /MWhr =	271	
4	Texas Wires	6,107 GWh @ $ 24.5 /MWhr =	150	
5	Off-System Sales	4,745 GWh @ $ 15.6 /MWhr =	74	
6	Transmission Revenue - 3rd Party		94	
7	Other Operating Revenue		123	
8	Utility Gross Margin		2,179	