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BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application of Columbus Southern Power Company and Ohio Power Company for Administration of the Signatory Excessive Earnings Test Under Section 4928.143(F), Revised Code, and Rule 4901:1-35-10, Ohio Administrative Code	)))))))	Case No. 11-4571-EL-UNC Case No. 11-4572-EL-UNC

REPLY BRIEF OF COLUMBUS SOUTHERN POWER COMPANY AND OHIO POWER COMPANY

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INTRODUCTION

Columbus Southern Power ("CSP")[1] and Ohio Power Company ("OPCo") (collectively the "Companies") have met their burden of establishing that they did not have significantly excessive earnings in 2010. Except for Industrial Energy Users – Ohio ("IEU"), no party to this proceeding disputes that fact with respect to OPCo.[2] The only dispute is whether CSP also passes the significantly excessive earnings test ("SEET") in Section 4928.143(F), Revised Code.

CSP, however, clearly met its burden and passes the SEET as well. It established, based on a scientific methodology uniquely designed to be give effect to each of the terms used in the statute, that its earned return on equity ("ROE") was not significantly in excess of the ROE of "publicly traded companies, including utilities, that face comparable business and financial risks." R.C. 4928.143(F). CSP is the only party to this proceeding to put forth a comprehensive, conceptually-sound comparative analysis tied directly to the statute. The Staff's alternative method for selecting a comparable group utterly fails to take into account the statutory mandates that the group include companies other than utilities and that the companies in the group face comparable business and financial risks. The Staff's methodology also fails to take into account that a refund is permissible only if CSP's ROE is "significantly in excess" of the ROE for a properly determined control group and, instead, offers an arbitrary baseline ROE that

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[1] CSP no longer exists due to its merger into OPCo in 2011. In 2010, CSP and OPCo were not merged and had submitted separate financial reporting. As such, the two companies were treated separately for purposes of SEET. For that reason, this brief continues to refer to CSP even though OPCo now represents the interests of the former CSP.

[2] The other intervenors are the Office of the Consumers' Counsel ("OCC"); the Ohio Energy Group ("OEG"); and Ohio Partners for Affordable Energy ("OPAE").

admittedly fails to take into consideration all the factors that the Staff concedes should be considered to make a final determination.

The other parties dispute that CSP's 2010 ROE is 17.54%, as determined by both CSP and the Staff, by continuing to challenge the Commission's prior determination that off-system sales ("OSS") should be excluded from this calculation. They concur, however, with the Staff's erroneous conclusion that the comparable group need not include companies other than utilities and may include companies with dissimilar business and financial risks. They also generally concur with Staff that the SEET threshold can be determined by simply imposing an arbitrary adder on the mean ROE for an incomparable group, although they disagree as to whether the adder needs to be adjusted, as the Commission previously determined in the 2009 SEET case, Case No. 10-1261-EL-UNC, Opinion and Order (January 11, 2011) ("*SEET I*") at 25-27.

The Commission must make its decision in this case based on what the statute requires it to consider. It may not ignore the statutory language. It may not arbitrarily pick a threshold against which to measure CSP's ROE. And it may not simply make a judgment call as to what a reasonable threshold might be. It must "explain its rationale, respond to contrary positions, and support its decision with appropriate evidence." *In re Application of Columbus S. Power*, 128 Ohio St.3d 512, 2011-Ohio-1788 at ¶ 30. CSP has provided the Commission with a rational approach for administering the SEET and has supported its conclusions with substantial and probative evidence. The Staff and the intervening parties have failed to do so and have failed to provide any credible justification for rejecting CSP's position.

ARGUMENT

A. CSP established, and the Staff concurs, that CSP's 2010 ROE was properly determined to be 17.54%.

CSP determined that its 2010 ROE was 17.54%. The Staff reviewed CSP's calculations and supporting information and found them to be "in conformance with the SEET calculation methodology as approved by the Commission" and to be an accurate representation of CSP's 2010 earnings. (Staff Ex. 1 at 3.) The intervenors disagree because they would have the Commission require CSP to include off-system sales in its 2010 earnings and/or they disagree with how CSP adjusted its equity base to exclude OSS earnings. (OEG Br. at 4; OCC Br. at 11; OPAE Br. at 1; IEU Br. at 10.) The Commission, however, previously determined both that the exclusion of OSS earnings is appropriate and that the exclusion should be accomplished by deducting OSS profits from total earnings and deducting from the equity base that part of equity which finances the generation for OSS. In the Companies' prior SEET proceeding, the Commission, after fully considering the argument the intervenors again make here, concluded:

> We are required to consider not only whether the electric utility had significantly excessive earnings but also whether its earnings are the result of adjustments in its ESP. Where it can be shown that the electric utility received a return on its OSS, which if included in the calculation would unduly increase its ROE for purposes of SEET comparisons, OSS margins and the related equity in generation facilities should be excluded from the SEET calculation. Thus, without reaching the federal and constitutional law arguments, we will exclude OSS and the portion of generation that supports OSS from the SEET analysis.

SEET I at 30.

The Commission's prior decision regarding the exclusion of OSS is presently pending before the Ohio Supreme Court in Case No. 2011-751, and the Commission is affirmatively advocating that the Court affirm its decision as proper. Given the present posture of *SEET I*, it would be highly inappropriate for the Commission to reverse itself in this case. Nor have the intervenors offered any new arguments as to why the Commission should reverse itself and include OSS earnings in the SEET analysis. Moreover, as CSP previously argued in *SEET I*, the exclusion of OSS not only is consistent with the requirement in R.C. 4928.143(F) that the SEET focus on earnings that result from adjustments in the ESP, which by definition are limited to retail earnings, but the exclusion of OSS earnings also is required to avoid a conflict with federal law. Under well-established federal constitutional law, the State is preempted from interfering with an electric utility's ability to realize revenue rightfully received from wholesale power sales. *Pacific Gas & Electric v. Resources Comm.* (1983), 461 U.S. 190; *Natahala Power & Light Co. v. Thornburg* (1986), 476 U.S. 953; *Mississippi Power & Light v. Mississippi* (1988), 487 U.S. 354. Just as the State may not trap federally-approved wholesale power costs, it may not siphon off the revenue Ohio utilities receive from wholesale power sales for the purpose of reducing or refunding retail charges paid by Ohio customers.

OEG suggests that a different result can and should be reached in this case without disturbing the Commission's prior precedent or current position before the Ohio Supreme Court. It argues that the Commission's prior order required the utility to show as a threshold matter that including OSS earnings would unduly increase the utility's ROE. OEG argues that CSP did not make this threshold showing. (OEG Br. at 6.) The argument makes no sense and has no merit. It is non-sensical because no intervenor in this proceeding would be arguing that OSS earnings should be included if the effect of their inclusion was to decrease the utility's ROE. It has no merit because, even assuming the Commission did intend to require this information (and further assuming the Commission may blur the line between federal and state jurisdiction so long as its actions do not capture wholesale profits to give retail rate relief), Companies witness Mitchell detailed the effects of including and excluding OSS margins. See Cos. Ex. 2 at TEM-1. The effect of including OSS margins in the ROE calculation, as presented by Mr. Mitchell, would be to increase the numerator by $47,224,000 and to increase the denominator by $114,003,000. CSP's ROE would increase from 17.54% to 19.42%.

OEG also criticizes Companies witness Mitchell's methodology for excluding OSS earnings because only the variable expenses, and not the fixed expenses, associated with OSS were eliminated in the determination of OSS earnings. (OEG Br. at 7-9.) As Companies witness Mitchell explained, however, there was no need to allocate the fixed expenses to the OSS because his methodology – a methodology accepted by the Commission in the prior proceeding – calculates the incremental out-of-pocket profit from a marginal transaction with and without the transaction. (Tr. v. I at 81-83.) Fixed costs are irrelevant because the Companies do not incur fixed costs to make wholly-discretionary, opportunistic OSS. The Companies' fixed costs are required to discharge their obligations as load serving entities and providers-of-last resort in Ohio. OEG's criticism also fails to appreciate that the SEET statute asks whether provisions in the utility's ESP resulted in excessive earnings. Earnings from OSS are irrelevant to the SEET because they do not arise from adjustments made in the ESP.

B. The SPDR Select Fund – Utility (XLU) does not meet the statutory requirements for a comparable group.

The Staff's methodology, which the intervenors also advocate, does not meet the requirements set forth in R.C. 4928.143(F). The record before the Commission quite clearly establishes that the SPDR Fund does not include publicly-traded companies other than utilities and that the utilities included in the SPDR are not selected because they have business and financial risks comparable to CSP and OPCo. (Staff Ex. 1 at 4; Tr. v. I at 138-39.) Indeed, Staff witness Buckley candidly admitted that the independent group that creates the SPDR "[has] different goals in selecting their group than we would in establishing baseline ROE." (*Id.* at 138.)

Mr. Buckley also acknowledged that use of the SPDR Index creates "the same comparable group for all of the Ohio electric distribution utilities. (Tr. v. I at 139-40.) The Staff offered no explanation for how this result can be reconciled to the Commission's prior determination that it would not be prudent to pre-determine an independent comparable group as the comparable group for the SEET because "each electric utility is unique, and conditions are constantly changing," *In the Matter of [SEET Investigation]*, Case No. 09-786-EL-UNC Finding an Order (June 30, 2010) ("*SEET Investigation Order*") at 29. See also *SEET I* at 21 (expressing concern about using a pre-determined proxy group that has no any direct relationship to the utility and that "produces the same comparable group of companies for all Ohio's electric utilities").

While the SPDR proxy is, as the Staff suggests, simple and expedient, the Commission cannot adopt a methodology that does not conform to the statutory requirements, just because it is expedient. The Commission is a creature of statute and must follow the law. *Tongren v. Pub. Util. Comm.*, 85 Ohio St.3d 87, 88, 1999-Ohio-206, 706 N.E.2d 1255; *Canton Storage and Transfer Co. v. Pub. Util. Comm.* (1995), 72 Ohio St.3d 1, 647 N.E.2d 36. The Staff's suggestion (at 5) that the Commission is free to ignore the statutory requirements because its proposal, though not conforming, is close enough, has no precedent and, is not a rationale the Commission can comfortably advance to the Ohio Supreme Court.

The Staff's alternative rationale for its statutorily-invalid proposal likewise is unsound. The Staff argues (at 5) that it behooves everyone to utilize a method that is "readily reproducible by a professional outsider" because it will reduce the uncertainty created by the SEET process. The Staff's predictability rationale assumes that the Commission will adopt a pre-determined objective and independent proxy to which each Ohio utility's ROE will be compared at the end of each year. The Commission previously rejected just such approach for the obvious reason that the Ohio utilities do not face the same business and financial risks. Thus, the Staff's proposal will disadvantage or prefer different utilities at different times by understating or overstating the appropriate baseline. The Staff's rationale for the independent proxy approach also ignores the fact that the Staff is advocating that the proxy determine only a "baseline" that the Commission will then adjust up or down based on wholly subjective factors. The second half of the Staff's two part proposal makes it impossible for a professional outsider to reproduce or predict the Commission's likely outcome and increases the level of uncertainty.

Finally, should the Commission adopt the Staff's "objective, readily reproducible" approach, the Commission and all interested parties would have to live with the fact that in any given year the proxy could produce a result higher than that produced by a statutorily-compliant method that is in fact based on the ROE of "publicly traded companies, including utilities, with comparable business and financial risks." For example, if the Commission had employed the SPDR proxy in the Companies 2009

SEET analysis, it would have assumed as its baseline an ROE of 11.39%, instead of the 11% actually employed, the 10.97% recommended by the Staff, or the 9.58% recommended by the Customer Parties. *SEET I* at 17-20. This one change would have reduced the amount ordered to be refunded to customers by 29%.

For all these reasons, the Commission should reject the Staff's proposal to use the SPDR to generate a baseline ROE and then adjust the baseline to a threshold using wholly subjective factors. The Commission instead should adopt the comparable risk peer group presented by Companies witness Dr. Makhija because it – and it alone – fully conforms to the statutory requirements by selecting those publicly traded companies, including (but not limited to) utilities, that face business and financial risks comparable to those faced by CSP. Dr. Makhija's methodology is scientifically sound and uses well-accepted metrics, such that all parties can feel comfortable with the independence, accuracy, and fairness of the result reached. If, however, the Commission elects to accept the Staff's expedient methodology, notwithstanding the statutory language, it should at a minimum correct the obvious flaws in the Staff's implementation of the proxy, as pointed out in CSP's initial brief (at 32-34) and find that the baseline ROE for purposes of the SEET is 11.42%, not the 10.97% the Staff ultimately landed on.

C. The Baseline + Adder approach does not meet the statutory requirements for implementing the SEET.

The Staff and intervenors advocate a two-part methodology that has the Commission first determining a "baseline" ROE which equals the mean of the ROEs of the comparable companies and then adjusts that baseline using wholly subjective factors to reach a "threshold" to be compared to CSP's ROE. There is no authority for this baseline + adder approach in R.C. 4928.143(F). The statute provides that the

Commission is to determine whether the utility's ROE is significantly excessive in comparison to the ROE of comparable companies. The statute gives the Commission discretion to take into account only one additional factor – the capital requirements for future committed investments. Thus, the Commission may determine that a utility's ROE, though objectively excessive in comparison to that of comparable publicly traded companies, is not significantly excessive for purposes of the statutory test if the utility has committed future investments that justify the need for additional capital. The statute makes no provision for the type of subjective adder analysis advocated by the Staff and intervenors.

The genesis of the baseline + adder approach is, of course, the Commission's conclusion in *SEET Investigation* (at 29) that "'significantly excessive earnings' should be determined based on the reasonable judgment of the Commission on a case-by-case basis," which was followed by a non-inclusive list of certain factors the Commission would at least consider. This conclusion is plainly wrong in that it violates the most fundamental rule of statutory interpretation – namely, that the language used in the statute controls. *In re Columbus S. Power Co.*, 128 Ohio St. 3d 512 at ¶ 34. While CSP continues to maintain that the statute is too vague to be enforceable, one point can be comfortably made with certainty. The statute does not contain any language from which one might infer that the SEET is to be based on the case-by-case judgment of the Commission applying factors not mentioned in the statute. If this was not clear before, it certainly is now in light of the Ohio Supreme Court's conclusion in *In re Columbus S. Power Co.* that the General Assembly's express delineation of the provisions to be included in an ESP means no other provisions can be added in the Commission's discretion. *Id.* Thus, the only subjective factor the Commission may consider in implementing the SEET is the utility's future committed investments. Except for that single expressly authorized "adder," the Commission must implement the SEET based upon an objective determination of whether the utility's ROE is "significantly excessive" in comparison to that of comparable publicly traded companies.

As Companies witness Dr. Makhija explains, the proper objective way to determine whether an outcome is "significantly" different in comparison to other comparable situations is a statistical construct that most commonly is set at two standard deviations from the mean. (Cos. Ex. 3 at 29-34.) This is the test routinely used in all types of physical science and social science inquiries. In fact, the standard deviation test is so commonplace as the accepted test for determining the significance of a different observation or result in comparison to a norm or mean result, it is reasonable to conclude that the General Assembly chose the term, "*significantly* excessive" specifically to connote an objective mathematical approach rather than the subjective adder preferred by Staff and intervenors.

The Commission has never offered any explanation for its rejection of the statistical analysis put forth by the Companies in either the generic SEET investigation or in their 2009 SEET proceeding. In *SEET Investigation* (at 28) the Commission states only that it fully considered all the comments, but concludes that "'significantly excessive earnings' should be determined based on the reasonable judgment of the Commission on a case-by-case basis." It did not explain why the statistical analysis sponsored at that time by both the Companies and the Staff was "insufficient by itself" to satisfy the statute and it did not discuss its rationale or authority for its "reasonable judgment" conclusion. The Commission did little more to justify its conclusion in *SEET I* other than to express its opinion that the statistical analysis relied on by the Companies "produc[ed] an unrealistic and indefensible result." *SEET I* at 24. That observation, however, defies the law of science. A statistical analysis, properly conducted, cannot produce unrealistic or indefensible results. The Commission's judgment that a ROE of 22% is too high for an Ohio utility does not mean that it is "significantly excessive" compared to comparable companies when it has been shown that the number is properly derived using an established scientific method and when, in fact, comparable companies actually earned ROEs at that level and higher. (Cos. Ex. 3 at Table 1, Panel D.)

For all these reasons, the Commission should reject the baseline + adder approach and find that CSP met its burden of establishing that its 2010 ROE was not significantly excessive in comparison to the ROE of publicly traded companies with comparable risks. While the Commission may not like that result, and may wish the General Assembly left it up to the Commission to use its own judgment to determine whether CSP's ROE was too high, the Commission must follow the law as written.

D. There is no reasonable rationale for employing only a 50% adder.

Should the Commission continue with the statutorily-unauthorized baseline + adder approach, however, it must explain its rationale for the adder it selects and support its decision with evidence in the record. *In re Columbus S. Power Co.*, 128 Ohio St.3d 512 at ¶ 34. The Staff takes no position on what the adder should be. Intervenors propose a 50% adder or less. Intervenors suggest that a 50% adder is reasonable based on nothing more than the fact that the Commission assumed so in the prior proceeding. *SEET I* at 27. The Commission's rationale for agreeing to the 50% adder *as a starting* *point* to transform the baseline to the threshold, however, is flawed. In *SEET I*, the Commission accepted the Staff's rationale that a 50% adder was a reasonable starting point because the impact of that adder equated roughly to the company's cost of debt. *Id.* The statute, however, requires the Commission to determine the threshold to which the utility's ROE will be compared based upon the metrics of the comparable publicly-traded companies and not the utility itself. The statute does not state that the Commission should require the utility to refund earnings found to be greater than the average ROE of a comparable group as adjusted to account for the utility's cost of debt. Moreover, as with the 2009 SEET proceeding, the evidence in this case shows that a 50% adder does not provide a reasonable threshold because it equates to less than roughly one standard deviation from the mean. No party has provided the Commission with any evidence that this small a deviation may be considered to be "significant."

While the intervenors are generally content with a 50% adder, OCC takes an even more aggressive position. It argues that the Commission should adjust the 50% adder downward by some amount, although it takes no position as to what that amount should be, because CSP's capital investments are forecasted to be less in 2011 than they were in 2009 and because CSP "over-stated its projected capital commitment for 2010" in the 2009 SEET proceeding. (OCC Br. at 9.) OCC's position is unfounded. The statute directs the Commission to consider the utility's "capital requirements for future committed investments." The statute does not state or imply that the consideration should focus on whether the utility expects to increase its investment over a prior year or on whether the utility was able to complete all the capital improvements it committed to undertake in a prior year. Forecasted capital expenditures of $187 million equate to a very substantial investment in Ohio, for which a very substantial source of capital is obviously required. The need for capital to support this level of investment, coupled with the well-documented and unique risks CSP faces in the current regulatory environment, requires a positive response from the Commission in its application of the SEET. Moreover, there is no rational reason for penalizing CSP for not spending the full amount it expected to spend in 2010. As Mr. Hamrock explained, the two major contributors to the difference between forecasted capital expenditures and actual in 2010 were the grant CSP received from the Department of Energy to support the gridSMART program and the timing of certain environmental expenditures tied to generation output. (Tr. v. I at 52-54.) OCC, in essence, asks the Commission to punish CSP for being a good steward of its resources.

E. CSP has met its burden of showing that significantly excessive earnings did not occur.

CSP has demonstrated, using Dr. Makhija's well-designed, well-executed, scientifically-supported methodology, directly tied to the statutory language, that CSP's 2010 ROE of 17.54% is not significantly excessive. If the Commission wants an alternative to confirm the reasonableness of this conclusion – a "sanity check" of some sort – it can note that even if it follows the approach used in the prior proceeding (baseline + 60%), still no significantly excessive earning occurred. This observation holds true whether the Commission accepts CSP's comparable risk peer group's ROE of 11.48% or uses the corrected ROE for the SPDR group, 11.42%, shown in Companies witness Makhija's rebuttal testimony. (Cos. Ex. 3 11 at 2.) If the Commission wants re-assurance that CSP "deserves" its 2010 ROE, although this is not the statutory test, the Commission can consider the subjective factors it requires all utility's to present in their

SEET application. CSP has put forth ample reasons why its business and financial risks are indeed significant, and more so than the risks faced by unregulated publicly traded companies, more so than the risks faced by utilities not operating in the unique hybrid environment now found only in Ohio, and more so than the risks faced by other Ohio electric utilities that do not own their own generation. (Cos. Ex. 1 at 12-21.)

OPAE and IEU argue that the subjective factors noted by Companies witness Hamrock should not be taken into account because CSP undertook the incentives it mentions as a matter of law or good practice, because CSP is compensated for the services it is providing, because the service or program is non-jurisdictional, or because the regulatory risks are not all that significant. (OPAE Br. at 4; IEU Br. at 13.) Intervenors criticisms miss the bigger picture – CSP's initiatives have produced savings or benefits for Ohio and Ohio customers at a cost to the company. Companies witness Hamrock gave very specific examples of the initiatives the Companies have undertaken in this current ESP period and the risks they confront doing business in Ohio. Intervenors' arguments do not change the facts.

IEU and OEG also argue that the Commission should take into account in this SEET proceeding the fact that the Companies were not required to refund the provider-of-last resort charges collected in 2010 but ultimately disallowed on remand in Case No. 08-917/918 El-SSO. (OEG Br. at 13; IEU Br. at 14.) It would be inappropriate for the Commission to take the absence of the refund of 2010 POLR revenues into account in this proceeding for the same reason that no such refunds were ordered in Case No. 08-917/918 EL-SSO, Order on Remand (October 3, 2011). The Commission did not order the refund of those charges because to do so would have constituted prohibited retroactive rate-making. It would be just as illegal to award a SEET refund based on the existence of those retained POLR revenues. *Id.* at 36 ("Consistent with the Court's precedent, we cannot order a prospective adjustment to account for past rates that have already been collected from customers and subsequently found to be unjustified.")

F. R.C. 4928.143(F) does not require the Commission to isolate an ROE for only that portion of the utility's earnings derived solely from adjustments in its ESP.

IEU again advances its theory that the Commission should require utilities to base their SEET application on only that portion of their earnings derived from adjustments in the ESP. IEU unsuccessfully pursued this theory in the Companies' prior SEET proceeding and is pursuing this theory as an appellant in Case No, 2011-751. The Commission is affirmatively defending its prior order on appeal, and IEU is merely preserving its rejected argument IEU presents no new arguments or justification for reversing the Commission's position, a position the Companies fully support.

IEU's criticism of using CSP's earned return on equity in the SEET analysis, rather than modeling an ESP-specific return on equity, is unfounded. R.C. 4928.143(F) states that the SEET is to determine whether the adjustments in the ESP 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." (Emphasis added.) The statute does not state or imply that the SEET calculation should include a determination of the earned return on equity for some other entity created to reflect only that portion of the EDU's business governed by the ESP. The statute cannot be re-written to conform to IEU's desired interpretation and outcome. *Lorain County Auditor v. Ohio*

Unemployment Comp., 113 Ohio St.3d 124, 129, 2007-Ohio-1247, 863 N.E.2d 133 at ¶ 24.

IEU relies on the fact that "electric distribution utility" is a statutorily-defined term to argue that R.C. 4928.143(F) must be read to require a completely remodeled entity, relying on some type of jurisdictional cost and revenue allocation study that somehow calculates a return on equity for only that portion of the EDU's business governed by the ESP – an "ESP-specific" return on equity. The definition of "electric distribution utility," however, clearly recognizes that an EDU may have multiple lines of business. R.C. 4928.01(A)(6) & (11). R.C. 4928.143 also recognizes that an EDU may have multiple lines of business, including retail electric service, distribution service, and transmission service. See e.g. R.C. 4928.143(B)(1) & B(2)(g)&(h). The General Assembly knew that an EDU could incur costs and derive revenue and earnings from activities and services outside of those tied to the rate adjustments in the ESP. Accordingly, had the General Assembly intended to limit the SEET analysis to a return on equity for some truncated or completely remodeled version of an EDU, it surely would have used apt wording to express that intent. *Id.* It did not.

CONCLUSION

For the foregoing reasons, the Commission should find that OPCo and CSP have demonstrated that neither company had significantly excessive earnings in 2010.

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PROOF OF SERVICE

I certify that Columbus Southern Power Company's and Ohio Power Company's Reply Brief was served by electronic mail and/or First-Class U.S. Mail upon counsel for all parties of record identified below this 10th February, 2012.

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