FILE

BEFORE THE
PUBLIC UTILITIES COMMISSION OF OHIO

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

APPLICATION FOR REHEARING OF OHIO POWER COMPANY

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APPLICATION FOR REHEARING OF OHIO POWER COMPANY[1]

On January 23, 2012, the Commission issued an Opinion and Order in the above-captioned cases (Opinion and Order). The Opinion and Order, among other things, determined that all of the realized value from a January 2008 settlement agreement (2008 Settlement Agreement) that terminated a 20-year coal procurement contract effective at the end of 2008 should be credited against Ohio Power Company's (OPCo's) 2009 Fuel Adjustment Clause (FAC) under-recovery and, thus, flowed through to the benefit of OPCo's retail customers that take standard service offer (SSO) generation service from OPCo. The "realized value" from the 2008 settlement agreement, according to the Opinion and Order, included both the portion of a 2008 lump sum payment from the coal supplier not already credited to OPCo's retail SSO customers as well as the purported value of a coal reserve that the coal supplier transferred in 2008 to OPCo.

Pursuant to § 4903.10, Ohio Rev. Code, and § 4901-1-35(A), Ohio Admin Code, OPCo (also referred to herein as "AEP Ohio") seeks rehearing of the January 23, 2012 Opinion and Order as further explained below. Specifically, the Compliance Entry is unlawful and unreasonable in the following respects:

I. The Commission should clarify that it did not intend to unreasonably and unlawfully flow through to the benefit of OPCo's Ohio retail customers amounts allocable to the wholesale and non-Ohio retail jurisdictions.

II. The Commission should clarify the methodology to be used for determination of the value of the coal reserve so that it can include, as an alternative to valuation

[1] As a result of the Commission's Opinion and Order in Case Nos. 11-346-EL-SSO et al., Columbus Southern Power and Ohio Power Company were merged effective December 31, 2011. Accordingly, references herein to Ohio Power Company, the surviving entity after the merger, include the predecessor interests of Columbus Southern Power.

through appraisal, the sale of the property after a final, non-appealable decision is reached in this case.

III. The Opinion and Order engages in selective and unlawful retroactive ratemaking. *Keco Industries, Inc. v. Cincinnati & Suburban Bell Tel. Co.* (1957), 166 Ohio St. 254; *Lucas Cty. Commrs. v. Pub. Util. Comm.* (1997), 80 Ohio St.3d 344.

IV. It is unreasonable and unlawful for the Commission to retroactively modify its prior adjudicatory decision in ESP I (Case Nos. 08-917/918-EL-SSO) to establish annual FAC audits to examine fuel procurement practices and expenses for the audit period. *Ohio Consumers' Counsel v. Pub. Util. Comm.* (2006), 111 Ohio St.3d 300, 318; *Ohio Consumers' Counsel v. Pub. Util. Comm.* (1985), 16 Ohio St.3d 9, 10

V. By reaching back into 2008 and using the results of fuel procurement activities in 2008 to offset fuel costs prudently incurred in 2009, the Opinion and Order unreasonably and unlawfully modified the FAC baseline that was fully litigated and decided in the *ESP I* Cases.

VI. OPCo prudently entered into the 2008 Settlement Agreement, and the Opinion and Order unreasonably and unlawfully impaired that agreement, especially given that the agreement was entered into by OPCo prior to commencement of the ESP's new FAC and before the 2009 audit period (*i.e.*, during a period of unregulated fuel cost and when fuel contracts were not regulated).

VII. The Opinion and Order unreasonably and unlawfully ignored the 2008 Production Bonus Agreement, which increased fuel expenses in 2008.

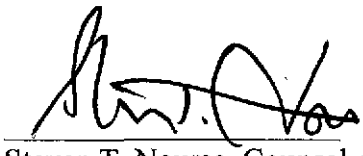
VIII. The Opinion and Order unreasonably and unlawfully concluded that the value of the coal reserve property acquired as a result of the 2008 Settlement Agreement should be offset against FAC costs because it is an OPCo asset on which ratepayers have no claim.

IX. The Opinion and Order erred by concluding that the Delivery Shortfall Agreement and the Contract Support Agreement may be examined by a future audit.

X. It is unnecessary to require AEP Ohio to add fuel procurement procedures as it updates its fuel procurement policy manual.

A memorandum in support is attached and sets forth the specific grounds supporting the above-listed errors.

Respectfully Submitted,



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MEMORANDUM IN SUPPORT

BACKGROUND

Enactment of SB 3 and Market-Based Pricing without FAC through 2008

Am. Sub. S.B. No. 3, effective October 5, 1999 (SB 3), restructured regulation of electric utilities and introduced retail customer choice for electric generation service, largely deregulating generation service in Ohio. Rates for competitive generation service were established based on a market-based pricing. Under SB 3, the Companies established a Rate Stabilization Plan (RSP) that was in effect from 2006 through 2008. Under the Companies' RSP, there was no fuel adjustment clause or comparable mechanism and there was no guarantee that the RSP's generation rates would cover the Companies' fuel costs during the RSP term. (Case No. 04-169-EL-UNC, January 26, 2005 Opinion and Order; March 23, 2005 Entry on Rehearing) As the Auditor in this proceeding stated, the RSP term was "a period in which fuel cost recovery was not regulated." (Audit Report at 1-6.) This was the status through the end of 2008.

Thus, the Companies were "on their own" with respect to recovery of fuel costs during the RSP period of 2006 through 2008. Indeed, during the RSP term, coal prices experienced unprecedented volatility and *tripled* between mid-2007 and mid-2008. (Audit Report at 2-4.) During the period from 2001 through 2008 when no FAC was in effect, the Companies' shareholders bore the total risk of increased fuel costs. The Auditor verified that during 2007-2008 period, coal prices in the United States reached all-time high prices. (Tr. I at 61.) As Companies witness Rusk testified, during the non-FAC period, not only did delivered costs for coal in Ohio increase dramatically, but there was also unprecedented volatility in coal markets.

(Cos. Ex. 2 at 15.) Material and volatile coal prices created ideal circumstances for having a FAC, but after AEP Ohio weathered this storm without one, the Commission now engages in "cherry picking" certain upside results achieved by AEP Ohio under its prior rate plan.

During this extraordinary historical period of coal procurement when fuel costs were not regulated, the Companies entered into several transactions to manage coal prices while maintaining a reliable supply. Included among the procurement transactions are four transactions that have been raised in this proceeding: (1) a January 2008 settlement agreement which terminated the 20-year contract with a coal supplier effective at the end of 2008 (2008 Buyout Agreement), (2) a November 2008 agreement with the same coal supplier for liquidated damages associated with a delivery shortfall occurring in 2008 (2008 Delivery Shortfall Agreement), (3) a 2008 agreement with a second coal supplier for contract support required to meet its financial covenants (2008 Contract Support Agreement), and (4) a February 2008 contract support agreement with a third coal supplier to help maintain the supplier's solvency through a production bonus payment and a temporary increase in the per ton price for coal (2008 Production Bonus Agreement). (Audit Report at 2-20 through 2-24.) None of these four transactions were found to be imprudent in the Audit Report or the Opinion and Order. In fact, the Auditor praised AEP management for its performance in managing this extraordinarily challenging period.

Enactment of SB 221 and the Adoption of a FAC mechanism for the Companies Starting in 2009

Am. Sub. S.B. No. 221, effective July 31, 2008 (SB 221), modified the method for setting standard service offer (SSO) rates for electric service and created new requirements for alternative energy, energy efficiency and peak demand reductions. On the effective date of SB 221, the Companies filed an Electric Security Plan in Case Nos. 08-917-EL-SSO and 08-918-

EL-SSO ("*ESP Cases*"). In deciding the *ESP Cases*, the Commission adopted a FAC mechanism for AEP Ohio, concluding as follows:

> The Commission believes that the *establishment of a FAC mechanism as part of an ESP is authorized pursuant to Section 4928.143(B)(2)(a), Revised Code, to recover prudently incurred costs associated with fuel,* including consumables related to environmental compliance, purchased power costs, emission allowance, and costs associated with carbon-based taxes and other carbon-related regulations. Given that the FAC mechanism is authorized pursuant to the ESP provision of SB 221, *we will limit our authorization, at this time, to the term of the ESP.*
> * * *
> Therefore, we find that the FAC mechanism with quarterly adjustments *as proposed by the Companies*, as well as an *annual prudency and accounting review recommended by Staff*, is reasonable and should be approved and implemented as set forth herein.

(*ESP Cases*, Opinion and Order at 14-15 (emphasis added).) Hence, the Commission approved the proposed FAC mechanism, pursuant to the new law that had been enacted for rate plans beginning January 1, 2009 (SB 221), for prospective operation during the term of the ESP (*e.g.*, the scope of the approved FAC was confined to begin in 2009 and end after 2011), with annual prudence reviews during the term of the FAC. The holding that the adopted FAC mechanism was strictly limited to the ESP term was reinforced in the entry initiating the RFP for the audit and again in the entry selecting the auditor for this proceeding. (*See* Case Nos. 09-872-EL-FAC and 09-873-EL-FAC, November 18, 2009 Entry at 1; ("The Commission limited its authorization of the fuel adjustment clause provisions to the term of the ESP."); January 7, 2010 Entry at 1 (same).)

In order to make the transition from a period where fuel costs were not regulated to an active FAC, the Commission needed to establish a FAC baseline to unbundle CSP's and OPCo's generation rates into fuel and non-fuel components. The Commission weighed the evidence carefully and found that a proxy is appropriate to establish a baseline, adopting Staff's method of using actual 2007 fuel costs and adjusting by 3% and 7% for CSP and OPCo, respectively. (*ESP*

Cases, Opinion and Order at 19.) On rehearing in the *ESP Cases*, the parties again advanced their positions and the Commission reiterated that it had fully considered the evidence and would not change its decision.

> [B]ased on the evidence presented in the record, the Commission determined that a proxy should be used to calculate the appropriate baseline. After making this determination, the Commission reviewed all evidence in the record and all parties' arguments, and adopted Staffs methodology and resulting value as the appropriate FAC baseline.

(*ESP Cases*, Entry on Rehearing at 6.)

Thus, the key FAC issues adjudicated and decided in the *ESP Cases* were that: (1) the FAC mechanism would be limited to the ESP period, excluding both the pre-ESP period and the post-ESP period; (2) annual prudence review of fuel costs would be conducted for fuel costs incurred in 2009, 2010 and 2011; and (3) the FAC baseline was set as a one-time determination to put the pre-ESP period fuel costs in the past and transition the Companies from a non-FAC period to an active FAC period. In short, establishment of the FAC baseline and other matters involving operation of the FAC mechanism during the ESP were hotly contested issues that the Commission fully adjudicated and decided in the *ESP Cases*. Notably, in establishing the FAC baseline and strictly confining the scope of the FAC mechanism to the ESP term, the Commission was explicitly aware at that time of the volatile coal prices and extraordinary coal procurement activities that occurred in 2008 in reaching its decision regarding the FAC baseline. (*ESP Cases*, Entry on Rehearing at 5.)

OVERVIEW OF ARGUMENT

As the Commission itself recognized, the 2007-2008 period involving volatile coal prices reaching all-time historical highs would have been an ideal time to have an active fuel clause mechanism. But AEP Ohio's rate plan at that time did not have an active fuel clause and the

Companies were on their own in managing fuel costs during this extraordinary period. AEP Ohio is not complaining because "a deal is a deal" and it agreed to the no-FAC Rate Stabilization Plan (RSP) in effect from 2006-2008. But the Opinion and Order sweepingly ignores this crucial fact and invite the Commission to selectively adjust rates that were charged during this period on a retroactive basis.

The Opinion and Order recognized this situation and noted the Auditor's high opinion of AEP's handling of the crisis:

> The auditors noted that since mid-2007, the coal industry has demonstrated *unprecedented volatility* which has resulted in *utility fuel procurement personnel facing enormous challenges*. Additionally, from mid-2007 until the third quarter of 2008, a global coal supply/demand imbalance increased the demand for and price of United States (U.S.) coals. *In the auditors' opinion, American Electric Power Service Corporation (AEPSC) did an exceptional job during this period particularly with those suppliers that faced financial difficulties.* Since the third quarter of 2008, electricity demand slowed as a result of the severe economic recession thus leading many utilities to end up with more coal under contract than needed. Thus, from mid-2007 through the end of 2008, electric utilities went from having to acquire coal under contract to having to manage a surplus of coal inventories. *In the auditors' view, AEPSC also did an outstanding job managing its excess coal inventories.*

(Opinion and Order at 3-4.) And the Commission specifically clarified (at 13) that it was not finding anything imprudent about AEP Ohio entering into the 2008 Settlement Agreement and was not finding any motivation by AEP Ohio to transfer value from ratepayers during the ESP to an earlier date.

The Opinion and Order unwisely accepted the invitation of IEU and OCC to "claw back" and to "claw forward" to capture transactions beyond the 2009 Audit Period. Specifically, in its Opinion and Order, at 12, the Commission "determine[d] that all of the realized value from the [2008] Settlement Agreement should be credited against OP's FAC under-recovery namely the portion of the $30 million 2008 lump sum payment not already credited to OP ratepayers as well

as the $41 million value of the coal reserve that AEP booked when the Settlement Agreement was executed."

In addition, while recognizing that the value of the coal reserve is not known, the Commission also directed AEP to hire an auditor specifically to examine the value of the coal reserve and to make a recommendation to the Commission as to whether the increased value, if any above the $41 million already required to be credited against OP's [FAC] under-recovery, should accrue to OP ratepayers beyond the value of the reserve that AEPSC booked under the Settlement Agreement. (*Id.*)

The Commission further determined, as to the purported benefits associated with the Delivery Shortfall Agreement and the Contract Support Agreement that intervenors (IEU and OCC) asserted should be factored into OPCo's FAC under-recovery, "any effect these agreements may have had on AEP-Ohio's fuel costs, if any, would appear to apply in time periods outside of the current [2009] audit." The Commission concluded by stating that while they "may be examined by a future audit, those agreements will not be further examined as part of the current audit." (Id. at 14.)

The rationale that the Commission provided in its Opinion and Order, at12-13, for seizing the $30 million 2008 lump sum payment not already credited to OP ratepayers as well as the $41 million amount associated with the coal reserve that AEP booked when the Settlement Agreement was executed from the 2008 Settlement Agreement and crediting those amounts against OPCo's FAC under-recovery was as follows:

> In making the above determination the Commission notes that the record reflects that the Settlement Agreement was entered into in order to terminate a long-term coal supply agreement, entered into in 1992, because the price of coal under the agreement was significantly below market in mid-2007. This long-term agreement was replaced with a new agreement which resulted in OP ratepayers paying significantly more for coal beginning in 2009, the start of the ESP period,

> than would have been paid had the Settlement Agreement not been entered into. We recognize that this situation is somewhat unique given that OP's fuel costs were not regulated during the period when the buyout occurred and the benefits booked yet the value was realized from coal that should have been delivered during the ESP period. While we do not find any motivation by AEPSC to transfer value from ratepayers during the ESP to an earlier date, nevertheless, the long-term coal agreement was an OP asset for which the value would have flowed through to OP ratepayers through the ESP period but for the extraordinary circumstances related to the early contract termination. Given these factors, we agree with Staff that, in order to determine the real economic cost of coal used during the audit period, more of the value realized by AEP for entering into the Settlement Agreement should flow through to OP ratepayers through a credit to OP's under-recovery and deferrals.

Respectfully, the Commission's "real economic cost" basis for reaching back into 2008, selectively extracting amounts related to the 2008 Settlement Agreement, and offsetting those amounts against OPCo's fuel costs in 2009 (and future periods) does not have a legal or record basis.

First, substantial portions of the $30 million lump sum payment and the $41 million recorded net book value are not related in any way to the Ohio retail jurisdiction and should not be used as an offset against OPCo's Ohio retail jurisdiction's fuel costs incurred in 2009 (and subsequent periods). They are related to the wholesale or other non-Ohio retail jurisdictions. Just as the expenses incurred by OPCo are jurisdictionalized prior to being recovered through the FAC, any amount of the lump sum payments and coal reserve asset that is to flow back through the FAC must be limited to the retail jurisdictional share. [Assignment of Error I]

Second, the Commission should abandon the notion of doing an audit/appraisal to determine the hypothetical value of the coal reserve asset. Instead, it should simply conduct a sale after the decision becomes final and non-appealable. A sale is the only way to determine the true market value of the asset. [Assignment of Error II]

Third, the Commission's economic cost rationale for making offsets against 2009 fuel costs, even with regard to portions of the $30 million lump sum payment and the coal reserve that arguably are associated with the Ohio retail jurisdiction, is fundamentally flawed. The "real economic cost" of the fuel costs incurred in 2009 for Ohio retail jurisdiction FAC customers is accurately measured by the amounts recorded on OPCo's books of account for 2009. There is a presumption that the costs incurred for fuel in 2009 are prudent, and there is no evidence that the costs that OPCo incurred to procure fuel in 2009 were imprudent. Indeed, the testimony and evidence, as well as the Commission's findings, confirm that the costs OPCo incurred for fuel, and properly recorded on its books of account, for 2009 were prudently incurred. Moreover, there is no basis for the Commission's statement that, as a result of the 2008 Settlement Agreement, OPCo paid significantly more for coal beginning in 2009, the start of the ESP period, than would have been paid had the Settlement Agreement not been entered into. The evidence confirms that the probable result, absent the 2008 Settlement Agreement, was that the supplier for the underlying coal contract would have defaulted and OPCo would have had to procure replacement coal at higher market prices. In addition, the Commission's rationale ignores the fact that OPCo incurred substantial additional costs in 2008 to provide support to another supplier which enabled that supplier to avoid defaulting on its coal supply arrangement, which allowed OPCo to continue to obtain coal supplies in 2009 and beyond at costs below what would have been incurred if that supplier had defaulted. OPCo did not seek to recoup those supplier support costs in 2009 (or future periods) through the FAC since these costs were incurred prior to the period when the FAC was reinstated. In sum, the Commission's rationale for reducing OPCo's

2009 FAC costs based on the 2008 Settlement Agreement is baseless. [Assignment of Errors III-VIII]

Fourth, there is similarly no basis for considering, in future FAC audit proceedings, whether other amounts associated with the 2008 Delivery Shortfall Agreement and a Contract Support Agreement should be offset against costs prudently incurred during future periods. The Opinion and Order erred by concluding that those agreements may be examined by a future audit. [Assignment of Error IX]

Finally, as a separate matter, AEP Ohio requests that the Commission clarify, on rehearing, that it is required in a subsequent FAC proceeding to report on its updated fuel procurement procedures. As was explained in its testimony on the subject, while it is appropriate to review and update the policies, the use of procurement procedures will not result in the efficient procurement of fuel at the lowest reasonable cost. [Assignment of Error X]

ARGUMENT

I. The Commission should clarify that it did not intend to unreasonably and unlawfully flow through to the benefit of OPCo's Ohio retail customers amounts allocable to the wholesale and non-Ohio retail jurisdictions.

It is unreasonable and unlawful to net against 2009 fuel costs amounts improperly and selectively extracted from the 2008 Settlement Agreement. The several ways in which such netting is unreasonable and unlawful are explained in detail below in subsequent sections of this pleading. As an initial matter, though, it is necessary to correct a threshold error in the Opinion and Order's language used to direct that all amounts resulting from the 2009 Settlement Agreement should be offset against OPCo's 2009 fuel costs. While the Commission presumably did not intend to confiscate non-jurisdictional gains, the literal language used in the Opinion and

Order suggests otherwise. Therefore, it must be corrected. Specifically, even if it were not unreasonable and unlawful to offset against OPCo's 2009 Ohio jurisdictional fuel costs amounts resulting from the 2008 Settlement Agreement, the Opinion and Order's directive substantially overstates the jurisdictional amounts available to be used as offsets against such costs.

AEP Ohio accounting witness Dooley testified that the $13 million credited against fuel costs in 2009 and 2010 did not directly relate to the $30 million cash payments (versus the $41 million net book value of the reserve asset). (Tr. I at 122.) He also clarified that the FAC customers would have only received a portion (*i.e.*, the retail jurisdictional allocation) of the $13 million that was assigned to 2009 and 2010. (*Id.*) The Financial Auditor, Mr. Ralph C. Smith of Larkin & Associates, testified that he fully understood that expenses reflected in the AEP Ohio accounting ledgers were allocated as between retail and non-retail expenses before being included in the FAC. (Tr. I at 15-16.) AEP Ohio witness Nelson also addressed the notion of applying the entire proceeds of the 2008 Settlement Agreement to the FAC:

> All of the amounts that have been discussed in the Audit Report and in the Companies' testimony associated with the 2008 Settlement Agreement are total OPCo amounts. OPCo's total generation output greatly exceeds its retail sales. Therefore, had a fuel clause existed in 2008, the impact on the retail fuel deferral would have been only a portion of the total OPCo amounts that were discussed in the Audit Report.

(AEP Ohio Ex. 3 at 8.) In short, the record is clear that FAC-related expenses and revenues are always allocated into retail and non-retail jurisdictional buckets that cannot be indiscriminately lumped in together. Application of this fundamental ratemaking concept to the factual record in this case is a straightforward matter, as follows.

The total proceeds from the transaction at issue were $71.4 million ($30 million cash and the coal reserve, valued at $41.6 million). The transaction was recorded as a gain in 2008 of

$58.3 million and as a gain in 2009 and 2010 totaling $13.3 million.[2] None of the $58.3 million 2008 gain affected the FAC (it was used as an offset to 2008 fuel costs), but the Ohio retail share of the $13.3 million did reduce fuel costs and thereby the FAC in 2009 and 2010, respectively. The total company gain that has not been credited to FAC fuel costs is derived as follows:

Description	Amount (in millions)
Cash	$30.0
Coal Reserve	$41.6
Total Company Proceeds	$71.6
2009/2010 allocation of Proceeds to fuel costs	$13.3
Total Company Gain not credited to FAC fuel costs	$58.3

On rehearing, the Commission needs to clarify that only the *Ohio retail jurisdictional share* of the $58.3 million gain[3] may be considered for use as offsets against OPCo's retail jurisdictional fuel costs.

II. The Commission should clarify the methodology to be used for determination of the value of the coal reserve so that it can include, as an alternative to valuation through appraisal, the sale of the property after a final, non-appealable decision is reached in this case.

If the Commission is going to seize the value of the coal reserve asset over AEP Ohio's objections, it should be done through a sale of the asset – not by conducting an appraisal or estimating a hypothetical value. The only way to determine the actual value the coal reserve asset is to sell it. The Auditor had the same opinion and Staff counsel made a special point of bringing this out as their only redirect examination of the Auditor during the hearing:

By Mr. Margard:

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[2] $13.3 million credit to fuel expense in 2009 and 2010. See discussion of the record on this point on pages 30-31 of AEP Ohio Initial Brief.

[3] The $58.3 million gain used in this example incorporates the $41.6 million net book value. If the asset is sold rather than appraised (see Assignment of Error II below), the actual net proceeds would be used in this calculation to see what, if any, additional funds would flow through the FAC. For example, the actual net proceeds could be greater than or less than the $41.6 million net book value.

> Q. Ms. Medine, you were asked a number of questions about risks associated with valuing the reserve here. Are there any ways to minimize the risks in valuating the reserve?
> A. I think the best way to get a feel for how much the reserve is worth is actually to sell it because through, you know, an appropriate process where you get as much competition as possible, then you can actually get a full value of the reserve and eliminate the risks because a third party would be assuming the risks related to capital or the risks related to market.
> MR. MARGARD: That's all I have, your Honor. Thank you.

(Tr. I at 116 emphasis added.) Based on that exchange, AEP Ohio limited its re-cross examination to the following question:

> By Mr. Nourse:
> Q. If the Commission were to order Ohio Power to sell the coal reserve, do you think that would positively or negatively affect the price that could be obtained in the market?
> A. If the public knew that you had to sell the coal reserve, is that your question?
> Q. Yeah.
> A. Obviously, that shows that it's a true sale, so it might actually generate additional interest in the market because they know that, in fact, you're going to transact. You're not just doing it for paper purposes. But obviously there's the risk that people might think you could get it at a fire sale, but I think generally it would show that it was going to happen, it was a real sale, and it wasn't simply to put a value on it.

(*Id.*) Thus, the record demonstrates that a sale, not an audit or appraisal, is the best method for determining the value of the coal reserve asset.

Of course, sale of the asset would permanently terminate OPCo's ownership of the asset and should not be undertaken until after the Commission's decision in this case becomes final and non-appealable (*i.e.*, after rehearing and appeals are decided). Taking this approach would not only determine the true market value, it would also save all of the time and expense associated with conducting and litigating a third-party appraisal. AEP Ohio could hire an independent consultant/ sales broker selected by Staff to oversee and conduct the coal reserve asset sale. Based on this competitive approach, the process and outcome of the sale could not be challenged in any subsequent proceeding. The costs

for hiring the broker/consultant would be deducted from the proceeds before allocating the net proceeds between retail and non-retail jurisdictions. Consistent with the discussion in Assignment of Error I above, only the retail jurisdictional share of the net sales proceeds would flow to retail customers.

Moreover, the Opinion and Order erred in providing that the audited value/ appraisal would examine whether "the increased value, if any above the $41 million already required to be credited against OP's under-recovery, should accrue to OP ratepayers beyond the value of the reserve that AEPSC booked under the Settlement Agreement." The appraisal of the current value may be less than the $41.6 million net book value and, if so, there should be an adjustment to any credit required under the Opinion and Order. The actual net proceeds would replace the $41.6 million net book value in the table above on page 14, to determine the retail share that should be credited, if any. Otherwise, requiring that the appraisal be done would be unfairly one-sided and would merely confirm that the Commission has not only confiscated the property but has required payment beyond its value.

III. The Opinion and Order engages in selective and unlawful retroactive ratemaking. *Keco Industries, Inc. v. Cincinnati & Suburban Bell Tel. Co.* (1957), 166 Ohio St. 254; *Lucas Cty. Commrs. v. Pub. Util. Comm.* (1997), 80 Ohio St.3d 344.

The Commission should avoid reversal by the Supreme Court by reconsidering and modifying the decision to confiscate OPCo's coal reserve asset and to retroactively modify the Commission-approved rate plan that was in effect during 2008. In Ohio, there is a constitutional prohibition against the retroactive application of statutes, see Section 28, Article II of the Ohio Constitution, and a statutory presumption in favor of prospective laws, see R.C. 1.48. SB 221

did not become effective until July 31, 2008 – the same date that the Companies filed their ESP application proposing a FAC mechanism starting in 2009. Because AEP Ohio's fuel costs were not regulated during the 2001 through 2008 period and because the ESP's FAC mechanism only became effective in January 2009, the FAC cannot be applied retroactively to encompass recognized transactions occurring in 2008. The same effect would result through any current prudence review of the 2008 contracts for the purpose of disallowing any portion of the ongoing cost impact of those contracts, which were entered into during a period of fuel deregulation when such contracts were not regulated. The Opinion and Order explicitly acknowledged (at 12-13) that "OP's fuel costs were not regulated during the period when the buyout occurred." Unfortunately, the Opinion and Order went on to clawback the value associated with the coal reserve asset.

The approach taken in the Opinion and Order violates the terms of the "FAC-less" RSP rate plan as well as the new FAC adopted in the *ESP Cases* and would amount to retroactive application of SB 221 in violation of the Ohio Constitution and Ohio Revised Code. The effect of the Opinion and Order is to retroactively increase 2008 fuel costs by confiscating the coal reserve asset value that was properly booked under GAAP as an offset to 2008 fuel costs.

This "clawback" credit amounts booked in 2008 during the prior rate plan (*i.e.*, the RSP period) would also violate the longstanding prohibition against retroactive ratemaking established in *Keco Industries, Inc. v. Cincinnati & Suburban Bell Tel. Co.* (1957), 166 Ohio St. 254. The key principles in the *Keco* decision form Ohio's version of the so-called "filed rate doctrine" and establish the following principles of strictly prospective ratemaking:

- Rates set by the Commission are lawful until such time as they are set aside by the Supreme Court and modified on remand by the Commission;

- A utility is entitled to and must collect the rates set by the Commission, unless a stay order is obtained; and

- No action for unjust enrichment lies to recover the rates that were subsequently determined to be unlawful because the comprehensive regulatory scheme in Title 49 abrogates any common law action in this regard.

(*Keco*, 166 Ohio St. at 256-259.)

The Supreme Court's decision in *Lucas Cty. Commrs. v. Pub. Util. Comm.* (1997), 80 Ohio St.3d 344, is part of the *Keco* progeny, *Ohio Consumers' Counsel v. Pub. Util. Comm.*, 121 Ohio St. 3d 362, 367 (Ohio 2009), and is also instructive. The *Lucas County* decision stands for the proposition that, because the Commission may exercise only that jurisdiction conferred by statute and none of the statutes in Title 49 authorizes the Commission to order refunds based on expired programs, the Commission could not order a refund after a pilot program was terminated. Thus, even where the Commission in retrospect disapproves of a utility decision or activity or cost that has already been incurred and collected by the utility pursuant to rates approved by the Commission, the Commission cannot "clawback" any revenue collected under a prior rate.

In addressing an analogous situation, the United States Court of Appeals for the Eighth Circuit Court memorably concluded that the applicable law was like a "fence that is hog tight, horse high, and bull strong" preventing the federal agency from exceeding its regulatory jurisdiction. *Iowa Utilities Board v. FCC*, 120 F.3d 753, 800 (8th Cir. 1997) (reversed in part and affirmed in part). Likewise, the filed rate doctrine under *Keco* and progeny is a bedrock principle of Ohio regulatory law that forms an impenetrable barrier preventing the Commission from engaging in retroactive ratemaking. As discussed below, not only is the Commission's decision unlawful, it is selective and one-sided retroactive ratemaking, ignoring other significant fuel expenses and losses incurred in 2008.

In its Opinion and Order the Commission attempted to avoid the prohibition against retroactive ratemaking established by *Keko* and *Lucas County*, stating:

> *Keco* does not apply in this situation. The Commission is not considering modifying a previous rate established by a Commission order through the ratemaking process as the Court considered in *Keco*. Rather, the Commission, by ordering the companies to credit more of the proceeds from the Settlement Agreement to OP's deferral balance, is establishing a future rate based upon the real cost of the coal used by the Companies to generate electricity during the 2009 FAC audit period. The proceeds AEP-Ohio received for entering into the Settlement Agreement are but one of the components which impact the Companies cost to provision electricity during 2009. Likewise, *Lucas Cty.* does not apply to the present situation. In *Lucas Cty.*, the Court held that the Commission was not statutorily authorized to order a refund of, or credit for, charges previously collected by a public utility where those charges were calculated in accordance with an experimental rate program which has expired. As noted above, the Commission has not made a determination modifying the rate the Companies collected during 2009. Additionally, there is no experimental rate program involved in the current case. Thus, *Lucas Cty.* does not apply in this matter.

Respectfully, the Commission's efforts to avoid *Keco* and *Lucas County* fail. By offsetting prudently incurred 2009 costs with amounts related to 2008, the practical consequence is that Commission has retroactively reduced the rates that OPCo charged customers in 2008 for SSO generation service by the amount of the offset to the 2009 costs. The argument that the offsets are necessary to determine the "real cost" of 2009 fuel has no basis. The real cost of fuel in 2009 are the costs paid by OPCo for fuel used to generate electricity during 2009. There is no basis for concluding that the actual costs incurred were imprudently incurred or inaccurately recorded on OPCo's books of account. Also regarding application of *Keco*, the Opinion and Order's defense (at 13), that the Commission is not considering modifying a previous rate established by Commission order, is without merit. As explained above, the impact of the Commission's decision is to modify the RSP rate plan that was approved by the Commission, by reaching back into 2008 (when fuel costs were not regulated) and clawback the fuel cost offset

properly booked in 2008. The fact that the "remedy" is a prospective adjustment to rates is unavailing as that is always true in cases involving unlawful retroactive ratemaking.

The effort to distinguish *Lucas County* is similarly flawed. The practical effect of the Commission's decision is to retroactively reduce the rates for generation service charged in 2008 by the amount of the offset made to costs in 2009. Because $58 million of the coal reserve asset value was properly booked as an offset to fuel costs in 2008 and the Commission is now unlawfully confiscating that asset, 2008 fuel costs have increased without any rate change or compensation to the Company, which is definitely an after-the-fact change to the RSP.

The Opinion and Order's statement (at 13) that it is merely engaging in fuel cost reconciliation and accounting, as was contemplated in the *ESP I* proceeding, is disingenuous. The Commission has not reconciled rates to prudently-incurred expenses as is normally done. Rather, it has increases the 2008 fuel expenses by retroactively modifying the Company's proper accounting without changing the rates actually charged and collected during that period. There was no reconciliation of FAC rates charged in 2009 to fuel costs incurred or booked in 2009. The latter is the purpose of an FAC mechanism and the former is unlawful retroactive ratemaking.

IV. It is unreasonable and unlawful for the Commission to retroactively modify its prior adjudicatory decision in *ESP I* (Case Nos. 08-917/918-EL-SSO) to establish annual FAC audits to examine fuel procurement practices and expenses for the audit period. *Ohio Consumers' Counsel v. Pub. Util. Comm.* (2006), 111 Ohio St.3d 300, 318; *Ohio Consumers' Counsel v. Pub. Util. Comm.* (1985), 16 Ohio St.3d 9, 10.

Two of the key FAC issues adjudicated and decided in the *ESP Cases* were that: (1) the FAC mechanism would be limited to the ESP period, excluding both the pre-ESP period and the post-ESP period; and (2) annual prudence review of fuel costs would be conducted for fuel costs

incurred in 2009, 2010 and 2011. (*ESP Cases*, Opinion and Order at 14-15.) In adopting the annual financial audit and prudence reviews, the Commission relied upon Staff witness Strom's testimony:

> Additionally, Staff recommended that annual reviews of the prudency and appropriateness of the accounting of FAC costs be conducted (Staff Ex. 8 at 3-4) * * * Therefore, we find that the FAC mechanism with quarterly adjustments as proposed by the Companies, as well as an annual prudency and accounting review recommended by Staff, is reasonable and should be approved and implemented as set forth herein.

(*ESP Cases*, Opinion and Order at 14-15.) In the Staff testimony relied upon by the Commission in adopting the FAC mechanism, Mr. Strom described the annual financial audit and prudence review as follows:

> A review of the appropriateness of the accounting of FAC costs, and the prudence of decisions made relative to the components of the FAC, should be conducted annually. I would expect the audit activities associated with these reviews to begin shortly before the end of each calendar year, and be concluded with an audit report to be filed by early March.

(Staff Ex. 8 at 4.) Thus, there was to be an annual financial audit and prudence review for each of the three years of the ESP relative to fuel procurement activity covered by each audit period and the entire scope of the approved FAC is to be strictly limited to the three-year term of the ESP.

These two key matters involving operation of the FAC mechanism during the ESP were fully adjudicated and decided as part of the Commission's decision in the *ESP Case* – the determinations are *res judicata* and cannot be re-litigated or re-applied on a retroactive basis. *Ohio Consumers' Counsel v. Pub. Util. Comm.* (2006), 111 Ohio St.3d 300, 318 (*res judicata* and collateral estoppel can apply to adjudicative Commission proceedings); *Ohio Consumers' Counsel v. Pub. Util. Comm.* (1985), 16 Ohio St.3d 9, 10 (same). As such, the Commission was

precluded from revisiting these issues during the term of the ESP – including in this 2009 FAC Audit proceeding.[4]

Indeed, the Commission confirmed in the Commission Entry initiating the RFP to select an auditor in this proceeding:

> The RFP sets forth a three-audit cycle in the Rider FAC audit process. *Audit 1 will be the Rider FAC in place from January 2009 through December 2009*. The scope for Audit 2 will be the Rider FAC in place during January 2010 through December 2010. The scope of Audit 3 will be the Rider FAC in place from January 2011 through December 2011.

(November 18, 2009 Entry at 1 (emphasis added).) This defined scope of audit is consistent with the decision in the *ESP Cases*, as described above, to review fuel procurement activities that occur during each annual audit period that occurs during the ESP term. The current proceeding involves Audit 1, reviewing activities "from January 2009 through December 2009."

The Audit Report issued by EVA also repeatedly acknowledged this limited scope of audit. (*See* Audit Report at 1-1 ("The initial audit covers the January through December 2009 period."), 1-3 ("the initial audit period should include the actual cost for the Rider FAC for the months January 1, 2009 through December 31, 2009").)

The Auditor agreed during cross examination that the scope of a FAC audit is generally constrained to reviewing costs incurred during the audit period. (Tr. I at 58.) Ms. Medine also agreed that, audits are normally limited to the audit period because there are discrete periods of

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[4] By contrast, the Commission may *prospectively* change its prior decisions as a general matter, as along as it reasonably justifies the change. See e.g. *Ohio Consumers' Counsel v. Pub. Util. Comm.* (1984), 10 Ohio St.3d 49, 50-51. And the Commission may entertain what would otherwise be considered a collateral attack in the context of crafting a prospective remedy in a complaint case filed under R.C. 4905.26. *Allnet Comm. Servs., Inc. v. Pub. Util. Comm.* (1987), 32 Ohio St.3d 115, 117. But those types of changes are only permissible if the decisional changes are made prospectively. And there is also an important legal distinction when it comes to changing an approved ESP plan; once an ESP is adopted under R.C. 4928.143 for a specified term, there is no indication that the General Assembly intended to allow the Commission to unilaterally change the ESP during that term.

review applicable to each audit – the current audit reviews the prior year's activities and the next audit reviews this year's activity, and so on. (*Id.*) Just because there are long-term impacts of prior fuel-related actions of the Companies, that does not mean that the prior rate plan should be abrogated.

The prior rate plan, the RSP (without a FAC), covered 2008 and the current rate plan, the ESP (with a FAC), covers 2009 costs. The Commission adopted the FAC baseline (discussed in greater detail below) to transition from the RSP to the ESP and neither the ESP nor RSP decisions should be disturbed. Any fuel procurement decision made by AEP Ohio during the time AEP Ohio's fuel costs were unregulated and were not subject to a prudence review under the regulatory compact applicable at that time. Doing so now in order to address continuing costs or a decision from a prior review period is akin to disallowing a contract that was already subject to prudence review in a prior case.

Notably, the Auditor agreed that a long-term coal procurement contract is normally only reviewed once for prudence in an audit. (Tr. I at 85.) Ms. Medine was asked whether, in all of her experience, she has ever observed a regulator going back after a contract passes a prudence review and subsequently making a disallowance associated with the contract based on a new determination that the contract is no longer competitive due to intervening market developments. Her unequivocal response was that "I've *never seen that done* in a regulatory setting." (Tr. I at 87 (emphasis added).)

Nevertheless, the Commission's Opinion and Order reaches back into the prior RSP rate plan and extracted value from an arrangement (the 2008 Settlement Agreement) entered into when fuel cost recovery was unregulated and when there was no prudence review of fuel procurement activity. The Commission in essence revisited a procurement contract that had

already been deemed prudent. The Opinion and Order, at 13, attempted to address this error as follows:

> [T]he Commission is not seeking to reach into another audit period in order to modify rates charged during the audit period but rather is rendering its decision in order to match the revenues and benefits incurred during the audit period. Nor has the Commission found that entering into the Settlement Agreement was imprudent. Again, the Commission is only finding that to determine the real economic cost of coal during the audit period, the Commission must consider both the revenues and the benefits received by the Companies pursuant to the Settlement Agreement and not rely solely on the price paid for coal during 2009.

Thus, the Commission once again attempts to rely upon its unsupported and (ironically) fictional "real economic cost" rationale to justify clawing back value from the prior rate plan for use as an offset against actual, prudently incurred, and accurately computed and recorded 2009 fuel costs. FAC costs and revenue for a given period are based on actual accounting book costs. The Company followed GAAP accounting for these costs and revenues and no party challenged the accounting as improper. For the reasons provided above, this rationale is without basis.

V. By reaching back into 2008 and using the results of fuel procurement activities in 2008 to offset fuel costs prudently incurred in 2009, the Opinion and Order unreasonably and unlawfully modified the FAC baseline that was fully litigated and decided in the *ESP I* Cases.

One of the key FAC issues litigated and decided in the *ESP Cases* was to establish the FAC baseline as a one-time determination to put the pre-ESP period fuel costs behind everyone and transition the Companies from a non-FAC period to an active FAC period. Establishment of the FAC baseline was a hotly contested issue that the Commission adjudicated and decided – the FAC baseline is *res judicata* and cannot be re-litigated or re-applied on a retroactive basis. *Ohio Consumers' Counsel v. Pub. Util. Comm.* (2006), 111 Ohio St.3d 300, 318 (*res judicata* and collateral estoppel can apply to adjudicative Commission proceedings); *Ohio Consumers' Counsel v. Pub. Util. Comm.* (1985), 16 Ohio St.3d 9, 10 (same). As such, the Commission is

precluded from revisiting these issues during the term of the ESP – including in this 2009 FAC Audit proceeding.

As discussed above, the decision in the *ESP Cases* left no room for re-examination of fuel costs outside the ESP term or limiting recovery of fuel costs within the term based on activity that occurred during the time when AEP Ohio was not operating under a FAC; rather, there was a clear and definitive separation of the ESP period from both the pre-ESP period and the post-ESP period (which makes sense given that the prior rate plan did not have a FAC mechanism and the term of the ESP ended after 2011). The mechanism to transition AEP Ohio from a non-FAC period to an active FAC period was to unbundle the fuel and base generation components of the pre-ESP generation rate to establish FAC and the non-FAC generation rates; the going-in FAC rate level for the ESP was referred to as the "FAC baseline." The FAC baseline was the mechanism to transition from the RSP where no FAC existed to the ESP which did include a FAC.

In litigating the *ESP Cases*, there were widely varying recommendations as to the appropriate FAC baseline:

- Staff's recommended using the 2007 actual fuel costs after adjusting them upward by the annual generation rate increases under the RSP of 3% for CSP and 7% for OPCo, in order to calculate a proxy for 2008 fuel costs. *ESP Cases*, Opinion and Order at 19.
- The Companies' recommendation was based on a rate unbundling methodology starting with the 1999 rates and updating them through rate plan adjustments. *Id.*
- OCC recommended using 2008 actual costs and delay the decision if necessary. (*Id.*)

The Commission weighed the evidence carefully and found that "a proxy is appropriate to establish a baseline. Therefore based on the evidence presented, we agree with *Staff's resulting value as the appropriate FAC baseline*." (*ESP Cases*, Opinion and Order at 19 (emphasis added) (citing Staff's Brief at 3).) In more explicit terms, the Commission specifically adopted Staff's

calculation that 2.625 cents/kWh would be the FAC baseline for CSP and 1.757 cents/kWh would be the FAC baseline for OPCo. (*ESP Cases*, Nelson Rebuttal at 5.)[5]

The primary reason to unbundle AEP Ohio's previously bundled generation rate into FAC and non-FAC components, by (i) determining the FAC baseline and (ii) subtracting it from the generation rate to get the non-FAC rate. But the Staff Brief (at 3), expressly cited and relied upon by the Commission in establishing the FAC baseline (per page 19 of the Opinion and Order), also addressed another reason for establishing a FAC baseline:

> In 2009, the proposed FAC would reflect projected costs. The first step in determining the FAC is to establish a baseline. *This is necessary to ensure that the FAC does not recover fuel costs already being recovered in rates.* The difference between projected costs and the baseline would determine costs to be recovered through the FAC.

(Staff Initial Brief at 3.) Thus, Staff suggested in their position (as expressly adopted by the Commission), that not only would setting the FAC baseline too low render the non-FAC rate too high going into the ESP, but a secondary effect of a baseline set too low would also be that the 2009 FAC rate impact or "bump" experienced by customers would be higher. Conversely, not only would setting the FAC baseline too high render the non-FAC rate too low going into the ESP, but a secondary effect of a baseline set too high would also be that the 2009 FAC rate impact or "bump" experienced by customers would be lower. In addressing their claim that anything other than actual 2008 fuel costs would understate the FAC baseline, OCC witness Smith also raised the same two concerns in her testimony:

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[5] Because the Commission's ESP Cases relied explicitly on Staff's position regarding the FAC baseline in the *ESP Cases* and since questioning by AEP Ohio's legal counsel of Mr. Hess in this case (who was the lead Staff witness in the *ESP Cases*) was abbreviated with respect to Staff's testimony in the *ESP Cases* about the FAC baseline (Tr. II at 243-244), AEP Ohio requests, to the extent necessary, that the Commission take administrative notice of the ESP testimony in this regard to fully consider that issue in light of intervenors' ongoing attempts in this case to undermine these aspects of the Commission's decision in the *ESP Cases*.

> One result is that it will appear that fuel costs are increasing more in 2009 than they actually are, and the FAC adjustment will be larger than if the 2008 actual fuel cost number had been used. Another result will be that the calculated base generation amount will be larger.

(OCC Ex. 10 at 11-12.) The Commission explicitly referenced this testimony in the Opinion and Order (at 19) in the *ESP Cases*.

A third impact of the FAC baseline relates to the interaction of the first two impacts. Namely, the higher FAC baseline advocated by OCC and IEU would have resulted in a lower non-FAC generation rate and created more "head room" when the 2009 projected fuel costs were added to the non-FAC generation rate going into the ESP plan, so that a larger rate increase could have been implemented to achieve the actual rate levels approved in the *ESP Cases*. But the Commission adopted the lower FAC baseline advocated by Staff (which result was similar to the lower FAC baseline advocated by the Companies, though based on a different methodology). In addition to creating a higher non-FAC generation rate, the lower FAC baseline adopted by the Commission resulted in less "head room" for the initial ESP rate increase. When this situation was coupled with the rate caps adopted as part of the modified ESP, it was a sheer certainty that large fuel deferrals would accumulate through implementation of the ESP. The Commission was well aware of the magnitude of 2009 fuel cost deferral/under-recovery anticipated under the rate cap/phase-in plan it adopted, especially for OPCo. (*ESP Cases*, Entry on Rehearing at 5.) Backing away from the fuel deferrals now would violate the regulatory compact and retroactively modify the prior rate plan approved in the *ESP Cases* when the Commission approved the fuel deferrals for future recovery through a nonbypassable surcharge on all customers in order to mitigate a larger initial rate increase.

Notably, IEU understood all three of these related impacts and explicitly raised them on rehearing in the *ESP Cases*, as IEU again advocated for use of 2008 actual fuel costs to establish the FAC baseline:

> Since 2008 actual fuel costs are now known, since they are significantly higher than the "proxy" adopted by the Commission, and since the "proxy" is, by definition, not the prudently incurred costs authorized in Section 4928.143(B)(2)(a), Revised Code, *the Order results in [1] the non-FAC portion of rates being too high and [2] the risk of increases in the FAC portion as well as [3] the amount of deferrals too great.*

(*ESP Cases*, IEU Application for Rehearing at 12.)

Of course, these are the same fuel deferrals being challenged by OCC and IEU on appeal from the *ESP Cases* before the Supreme Court of Ohio. See *Ohio Consumers' Counsel v. Pub. Util. Comm.* (Case No. 2009-2022; *Industrial Energy Users – Ohio v. Pub. Util. Comm.* (Case No. 2010-730.) And it is the same fuel under-recovery that OCC and IEU are again attempting to reduce or eliminate the recovery for OPCo in this proceeding. OCC witness Duann readily acknowledged that OCC has "many issues" with the Commission's decision regarding the FAC in the *ESP Cases*. Some of the ongoing objections of OCC/IEU regarding the original FAC decision include: not using the offset for off system sales, adopting a weighted average carrying cost for deferrals and establishing a FAC baseline that did not use actual 2008 fuel costs. Tr. II at 207-208. Since OCC and IEU have appealed some of those same issues before the Supreme Court of Ohio, they both obviously have an ongoing interest in attacking those issues whenever possible.

The Commission attempted to rationalize its decision as engaging in a "reconciliation" that is specifically contemplated by its decision in AEP Ohio's *ESP Cases*:

> [T]he Commission has not adjusted the baseline for the 2009 period as decided in the Companies ESP cases. Rather, the Commission, in this case is engaging in a reconciliation and accounting which was explicitly contemplated by the ESP

> cases in future FAC proceedings. Otherwise, there would be no rationale for adjustment to recognize extraordinary events affecting 2009 costs such that the Companies 2009 real costs will be comparable to the proxy baseline selected in the ESP proceedings.

What the Commission did was not a simple reconciliation of costs incurred in a prior FAC period with those collected in a subsequent FAC period. What the Commission did, as a practical matter was to "reconcile" the FAC baseline established in the *ESP Cases* into a higher value. That is not the type of "reconciliation" that the decisions in the *ESP Cases* contemplated. Whether the 2009 FAC-related increase in rates were reduced through adoption of a higher FAC baseline (as was advocated by OCC and IEU in the *ESP Cases*) or through a reduction of the current under-recovery/deferral (as is being advocated by certain intervenors in this case), the effect on OPCo is the same. In any case, the Commission established the FAC baseline to put the prior no-FAC period behind everyone and transition to the ESP's active FAC mechanism and it violates the decision in the *ESP Cases* to now reach back into 2008 for purposes of adjusting prudently-incurred costs in the current 2009 audit period. The decisions on these issues are *res judicata* and collateral estoppel prevents intervenors from re-litigating and the Commission from reversing its decision regarding the same issues in this proceeding.

VI. OPCo prudently entered into the 2008 Settlement Agreement, and the Opinion and Order unreasonably and unlawfully impaired that agreement, especially given that the agreement was entered into by OPCo prior to commencement of the ESP's new FAC and before the 2009 audit period (*i.e.*, during a period of unregulated fuel cost and when fuel contracts were not regulated).

The ESP plan was adopted prospectively to cover the 2009-2011 period and transition from the RSP period (where there was no fuel cost regulation) to the ESP period where the FAC mechanism was authorized to permit recovery of all prudently-incurred fuel costs. As such, any

ongoing effect of the 2008 agreements in the current 2009 review period cannot be retroactively modified or disallowed in this proceeding.

The Companies supported the prudence of the 2008 transactions through the testimony of Companies witnesses Dooley, Rusk and Nelson. And neither the Auditor nor any intervenor witness even conducted a prudence review of the 2008 agreements, let alone supported the view that any aspect of the agreements was imprudent. On the contrary, the Audit Report categorically concludes regarding the unprecedented coal procurement challenges of the 2007-2008 period (at 1-4) that "AEPSC did an exceptional job during this period particularly with those suppliers that faced financial hardship." Moreover, the Companies submitted unrebutted evidence that the 2008 transactions were properly accounted for per GAAP during a period when fuel costs were unregulated.

Companies witness Nelson provided testimony regarding AEP Ohio's overall position on this issue:

> At the time the 2008 Settlement Agreement was entered into, there was no FAC and no way to know that the FAC would be reinstated for the Companies in 2009. Also there is no guarantee that the Companies will always have an FAC in the future. Consequently, the Companies maintain that the Commission should limit its review in this proceeding to the audit period. OPCo is comfortable that the review will confirm that it made the proper entries on its books and that payments made or compensation received were treated in accordance with FAC/ESP commencement on January 1, 2009.

(Cos. Ex. 3 at 5.)

Companies witness Rusk testified that the 2008 Settlement Agreement came about because the coal supplier sought payment for change in law claims related to safety expenditures, increases it claimed should be allowed under the existing agreement, and indicated that it may not be able to deliver the existing contractual tonnage due to mining costs in excess of the contractual sale price to OPCo. (Cos. Ex. 2 at 11.) The coal supplier indicated that the contract

had been conceived without any expectation of its costs escalating so much and that this had resulted in revenues from the contract being less than their cost to produce. (*Id.* at 11-12.) In response, AEPSC performed an assessment of the claims. (*Id.*) While AEPSC expects its suppliers to honor the terms of their contracts, it also understands that disputes can result in litigation and that the contract in dispute will often not survive the legal process. (*Id.*) As Mr. Rusk testified, it was AEPSC's judgment that, in this instance, the best approach was to attempt to negotiate a resolution to the dispute that would optimize the value associated with the original agreement. (*Id.*)

The Commission specifically determined in its Opinion and Order, at 13, that it had not found that the Settlement Agreement was imprudent: "Nor has the Commission found that entering into the Settlement Agreement was imprudent." Utility decisions are presumed to be prudent. Accordingly, the presumption of imprudence coupled with the Commission's finding of no imprudence, in fact, confirmed the prudence of the Settlement Agreement. Yet, the practical effect of the Commission's decision is that it is amounts to a conflicting finding of imprudence with regard to OPCo entering into the Settlement Agreement. On rehearing this conflict must be resolved by reversing the directive to net amounts from the 2008 Settlement Agreement against 2009 fuel costs.

VII. The Opinion and Order unreasonably and unlawfully ignored the 2008 Production Bonus Agreement, which increased fuel expenses in 2008.

It is not reasonable to, on the one hand reach back to 2008 and bring value forward to the current review period, yet, on the other hand, to ignore the increased fuel costs resulting from other agreements during the pre-FAC time period. Yet, the Opinion and Order does just that with regard to the 2008 Production Bonus Agreement. (*See* Cos. Ex. 1 at 4-5; Cos. Ex. 2 at 16-

20; and Cos. Ex. 3 at 6.) The Commission's decision does not even mention the $28.6 million 2008 Production Bonus Agreement. Pursuant to this agreement, in order to assure that the supplier remained in business and able to provide coal at a below-market price levels during 2008 and after 2008, OPCo made a $28.6 million payment to the supplier. The payment increased 2008 fuel costs by that amount (and reduced 2008 earnings). OPCo properly did not seek to recover this cost, incurred during the pre-ESP/FAC regulatory structure, through 2009 FAC rates. However, this countervailing example supports OPCo's position that the Commission should not reach back beyond the audit period and extract value from the other 2008 agreements by reducing OPCo's 2009 FAC under-recovery balance. Alternatively, it provides an example of fuel costs incurred in 2008 that should be used to offset any claw back into 2009 of amounts relating to the 2008 Settlement Agreement.

VIII. The Opinion and Order unreasonably and unlawfully concluded that the value of the coal reserve property acquired as a result of the 2008 Settlement Agreement should be offset against FAC costs because it is an OPCo asset on which ratepayers have no claim.

The coal reserve is an asset sitting on OPCo's books and already properly accounted for in 2008 business. This asset was received in conjunction with the 2008 Settlement Agreement and properly accounted for in 2008.

Customers pay for electricity, not utility assets. Decades ago, the Commission settled the issue of whether ratepayers have an ownership in utility assets when CSP sold its ownership of the Conesville Coal Preparation Plant for a gain in 1988. In that case, the OCC argued that ratepayers should receive a portion of the gain because fuel clause ratepayers had purchased an ownership interest in the assets through their funding of the accumulated depreciation of the equipment. The Commission rejected OCC's argument and found as follows:

> The Commission believes that CSP's EFC ratepayers did not purchase an interest in the ... equipment through the equipment rental component included in the cost of ... coal. *The Commission does not find it appropriate to conclude that the actual nature of the rental component is similar to an installment sale.* The inclusion of an equipment rental component in the cost of coal does not confer the benefits or the risks of ownership of the equipment on those who pay EFC rates which include the cost of coal.

Case No. 88-102-EL-EFC, Opinion and Order (October 28, 1988) (emphasis added). In its December 20, 1988 Entry on Rehearing, the Commission again concluded that it "has no doubt that the ratepayers were not purchasing an ownership interest in the equipment" through the fuel clause rates and the Commission asked the rhetorical question of whether OCC would be before the Commission supporting a rate adjustment to the Company's favor based on this ownership theory had the equipment been sold at a loss.

The Commission's holding that customers do not enter into an installment sale for utility assets when they pay rates for service applies here with additional force, given that OPCo customers did not even pay a separate fuel rate for generation service during the pre-ESP period. Ratepayers have no claim on the coal reserve asset. In addition, there simply is no basis in the record to support a present value of the coal reserve asset. As Companies witness Rusk noted in his rebuttal testimony, the initial amount booked for the asset in 2008 was based on an October 2007 report done by an independent contractor and that was the only value known to AEPSC at the time the 2008 Settlement Agreement was entered into and accounted for. (Cos. Ex. 6 at 4-5.) Consequently, there is no legal basis for the Opinion and Order's seizure of value related to the coal reserve, which essentially converted it into a ratepayer-owned asset, and reducing 2009 (or future) fuel costs by the purported value of the asset.

Nor is there any basis for concluding that the reserve could be liquidated and sold for $41.6 million, let alone a higher amount. Yet, the Opinion and Order unreasonably and

unlawfully concludes that the reserve is worth at least $41.6 million and reduced the 2009 FAC costs by that amount. Thus, on top of illegally reaching back before the ESP/FAC period to extract value from transactions outside of and unrelated to the FAC audit period, the Opinion and Order fabricates value related to the coal reserve and then imposes on OPCo the obligation of guaranteeing that the coal reserve has a minimum value (of $41.6 million). There is no legal or record basis for such a decision and the Commission committed an unexplained departure from its own precedent in reaching this decision.

IX. The Opinion and Order erred by concluding that the Delivery Shortfall Agreement and the Contract Support Agreement may be examined by a future audit.

The Commission further determined in its Opinion and Order, at 14, with regard to the purported benefits associated with the Delivery Shortfall Agreement and the Contract Support Agreement, both of which OPCO also executed in 2008, that "any effect these agreements may have had on AEP-Ohio's fuel costs, if any, would appear to apply in time periods outside of the current [2009] audit." The Commission concluded by stating that while they "may be examined by a future audit, those agreements will not be further examined as part of the current audit." This conclusion is also unreasonable and unlawful for the same reasons provided above with regard to Assignments of Error III –VIII. In particular, it would involve selective and unlawful retroactive ratemaking; it would unlawfully use the results of fuel procurement activities related to 2008 and use them to offset fuel costs prudently incurred subsequent periods; it would unlawfully modify the FAC baseline that was fully litigated and decided in the *ESP Cases*; it would unlawfully impair agreements that OPCO prudently entered into in 2008; and it would unreasonably and unlawfully ignore the 2008 Production Bonus Agreement that increased fuel costs in 2008.

X. It is unnecessary to require AEP Ohio to add fuel procurement procedures as it updates its fuel procurement policy manual.

In its Opinion and Order, at 12, the Commission adopted the auditor's management/performance (m/p) recommendations 2 through 6 as outlined in the audit. AEP Ohio generally agreed with, or did not oppose, the auditor's recommendations 2-6. However, there is one respect in which AEP Ohio seeks clarification of the Commission's adoption of recommendations 2-6. In particular, in recommendation 5 the auditor recommended that AEPSC should finalize the update of its policies and procedures manual to reflect current business practices and that both the policies and procedures manual (and Conesville Coal Preparation Plant study) should be reviewed in the next m/p audit.

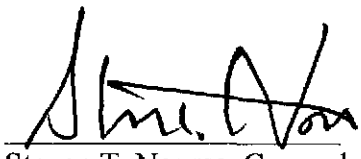
AEP Ohio witness Rusk testified and the Opinion and Order noted, regarding m/p recommendation 5, that AEPSC is currently updating its fuel procurement policies and planned to have those updates completed in time for the next m/p audit. However, as the Opinion and Order also noted, Mr. Rusk clarified that those revisions are focused on procurement policies, and not focused on fuel procurement procedures because AEP Ohio believes that policies, not procedures, result in the most efficient procurement of fuel at the lowest reasonable price.

AEP Ohio requests the Commission to clarify, on rehearing, that it is not necessary for AEPSC to update the fuel procurement policy manual to include procedures. Rather, AEP Ohio requests that the Commission confirm that it is required only to finalize updates to the fuel procurement policies and that the auditor is directed to review those updated policies in the next m/p audit proceeding.

CONCLUSION

The Commission's Opinion and Order is unlawful and unreasonable in several respects, as outlined above, and must be reconsidered and reversed.

Respectfully Submitted,



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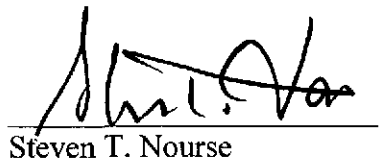
CERTIFICATE OF SERVICE

I hereby certify that a copy of AEP Ohio's Application for Rehearing was served on the persons stated below via electronic mail this 22nd day of February 2012.



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