BEFORE THE
THE PUBLIC UTILITIES COMMISSION OF OHIO

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

REPLY BRIEF OF FIRSTENERGY SOLUTIONS CORP.

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I. INTRODUCTION

Cost-of-service rate regulation of competitive generation service has ended in Ohio and does not apply to PJM's Reliability Pricing Model ("RPM"), but Ohio Power Company ("AEP Ohio") refuses to acknowledge these facts. AEP Ohio argues in its post-hearing brief that it had expectations in 2006 and 2007 that, because it elected to be a Fixed Resource Requirement ("FRR") Entity, traditional cost-of-service ratemaking would apply to the rates it charges for capacity required to meet PJM reliability requirements. This expectation, which is unsupported by fact and law, results in the distorted view presented throughout AEP Ohio's 113-page post-hearing brief. Because AEP Ohio remains entrenched in the cost-of-service world of the 1990s and earlier, it simply cannot understand how PJM's RPM functions. It does not understand that the FRR alternative is a part of the RPM and serves the same purpose – ensuring reliability – as the auction alternative that also is a part of the RPM. It does not understand that references to "cost" in PJM's Reliability Assurance Agreement ("RAA") are not references to guaranteed full embedded cost recovery under traditional utility regulatory concepts. To the contrary, the RAA reflects a modern, market-based concept that ensures reliability through compensation of marginal ("to go") costs at a level designed to keep resources in service.

AEP Ohio's error is in believing that the FRR alternative of the RPM "permits AEP Ohio the right" to charge for PJM's reliability-ensuring product – "capacity" – in the same manner that it traditionally has recovered the costs of its generating facilities. Yet the RPM is not a cost recovery mechanism; it is an incentive mechanism. Today's energy markets are the cost recovery mechanism through which the costs of generation resources are to be recovered. PJM's capacity product is a construct designed to ensure a certain level of reliability, not to

ensure that AEP Ohio is made whole for the cost of all of its generating facilities.[1] AEP Ohio is defining the full cost of all of its generating units as a capacity product, but that's not the capacity product PJM has constructed and certainly not the compensation structure PJM has defined. The RPM design offers compensation to capacity suppliers, whether they are FRR Entities or RPM auction participants, at the level necessary to ensure reliability by providing value on top of what the energy market provides. Nothing less, and certainly nothing more. Although AEP Ohio now claims that it had expectations that being an FRR Entity would give it the right to charge a full embedded cost rate for capacity, any such expectations are directly contrary to the RPM. AEP Ohio's election to be a monopoly provider of capacity through May 31, 2015, is not a ticket to go directly to Boardwalk.

Because AEP Ohio incorrectly has assumed that it is entitled/required to charge its full embedded costs for PJM's capacity product, AEP Ohio never considers what the correct price for this capacity is under the RPM construct. Only Intervenors and Staff have undertaken that task, and the universal answer is that AEP Ohio should receive compensation for PJM's capacity product consistent with the RPM's market design. That design defines how capacity should be valued to ensure reliability, and the RPM[2] auction results are the proper determination of that value. All other capacity suppliers in the RPM will be compensated for reliability using these auction results. Under RPM pricing, after accounting for scaling factors AEP Ohio will receive

[1] AEP Ohio consistently references and relies upon traditional cost-of-service concepts when promoting its FERC template, under which it provides cost-based energy and capacity to certain customers. Under this traditional approach, a customer purchases cost-based capacity and, in exchange for covering the utility's full embedded costs, is thereby entitled also to receive energy at cost. This is the opposite of the RPM design, under which generating resource owners are compensated for their costs through market-based energy prices and capacity is priced using market principles at the level necessary to ensure reliability.

[2] As used throughout FirstEnergy Solutions Corp.'s ("FES") Briefs, reference to "RPM pricing" or "RPM prices" refers to the RTO price resulting from the unconstrained BRA and incremental auctions for each given planning year.

$19.89/MW-day in the upcoming 2012/13 Planning Year, approximately $34/MW-day for the 2013/14 Planning Year and approximately $154/MW-day for the 2014/15 Planning Year because that is the value of the capacity needed to attain PJM's reliability metric for each of those years.[3] Thus, an RPM-based capacity price, which appropriately varies from year-to-year because the cost of ensuring reliability varies from year-to-year, is the just and reasonable compensation that AEP Ohio should receive as the state compensation mechanism.

Importantly, a market-based rate for PJM's reliability-ensuring capacity product is required by Ohio law and policies designed to promote competitive markets. The Commission has the option of establishing the state compensation mechanism precisely because Ohio has adopted competitive retail electric service. As set forth in Schedule 8.1, Section D.8 of the RAA, the state compensation mechanism applies whenever a state utilities commission requires shopping customers or competitive retail electric service ("CRES") providers (called "alternative retail LSEs" in the RAA) to pay an FRR Entity for PJM's reliability product:

> In the case of load reflected in the FRR Capacity Plan that switches to an alternative retail LSE, where the state regulatory jurisdiction requires switching customers or the LSE to compensate the FRR Entity for its FRR capacity obligations, such state compensation mechanism will prevail.

Since the market transition period established by S.B. 3 has ended, AEP Ohio "shall be fully on its own in the competitive market."[4] Any expectation that AEP Ohio has to receive traditional cost-of-service rates for its generation is contrary to Ohio law. The Commission now must "facilitate and encourage development of competition in the retail electric market."[5] The

[3] FES Ex. 101, Direct Testimony of Robert B. Stoddard, filed Apr. 4, 2012 ("Stoddard Direct"), p. 25; FES Ex. 103, Direct Testimony of Jonathan A. Lesser ("Lesser Direct"), p. 35. The 2013/14 and 2014/15 planning years are approximate because incremental auctions have yet to take place.

[4] R.C. § 4928.38.

[5] *AK Steel Corp. v. Pub. Util. Comm.*, 95 Ohio St. 3d 81, 81 (2002).

Commission also must protect consumers from AEP Ohio's abuse of market power and prevent AEP Ohio from obtaining an unfair competitive advantage.[6] By fixing the state compensation mechanism as the RPM delivered rate for each planning year, the Commission ensures that the state's policies are advanced.

Indeed, AEP Ohio's impending corporate separation, which has long been required by Ohio law, also mandates that the state compensation mechanism be based on RPM auction pricing. Once corporate separation is achieved on or before January 1, 2014, AEP Ohio will truly be "fully on its own in the competitive market." It will be free to acquire capacity at competitive market pricing in order to satisfy its FRR obligations. Of course, AEP Ohio has told this Commission that AEP management has instructed AEP Ohio to instead contract with AEP Generation Resources (the "GenCo") for capacity at an above-market price. But this Commission has no obligation to recognize that contract as valid. Indeed, as discussed in Section II.C. below, the FERC's own rules governing affiliate contracts instruct that any such contract for above-market pricing is invalid. AEP Ohio cannot be permitted to contract around the RPM market design. Post-corporate separation, an RPM-based capacity price also is the only appropriate state compensation mechanism because, among other things, it is the only price that fairly represents the competitive market pricing at which AEP Ohio should be acquiring capacity, and there is no valid reason for any other mechanism to be utilized in the meantime.

[6] R.C. §§ 4928.02(I), 4928.17(A)(2).

II. ARGUMENT

A. AEP Ohio Does Not Validly Counter The Multitude Of Reasons RPM Pricing Is The Most Appropriate Price For Capacity Provided To CRES Providers.

In its Brief, AEP Ohio cites no federal or state law that guarantees its right to recovery of its full embedded costs for capacity provided to CRES providers. To the contrary, as discussed in FES' Brief, such cost recovery is inconsistent with Ohio law, which establishes a competitive market for electric generation service.[7] Guaranteed recovery of full embedded costs also is inconsistent with PJM's RPM, which both AEP Ohio's and FES' expert witnesses agree is working well and providing the appropriate signals to generators to ensure reliability.[8] Thus, the Commission should set the state compensation mechanism based on the RPM price.

1. AEP Ohio's Brief Includes Gross Misrepresentations Regarding The RAA's Pricing Structure For FRR Entities.

AEP Ohio's argument that it has the "right" to establish a cost-based capacity price is not made in good faith and is not supported by reasonable grounds. Rather than simply arguing that the state compensation mechanism should be cost-based, AEP Ohio argues, on the one hand, that it has a "contractual right" to a cost-based rate[9] and, on the other, that the RAA allows AEP Ohio to file for a cost-based rate "at any time."[10] Its argument fails to acknowledge (or even bring to the Commission's attention) binding FERC precedent issued in their own FERC proceeding.

The FERC has explicitly ruled that the plain language of the RAA provides that an FRR Entity has the option to change to a cost-based recovery mechanism only when there is no state compensation mechanism in place. In its January 2011 Order, the FERC stated:

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[7] *See* FES Brief, pp. 10-12.

[8] *See* FES Brief, pp. 12-22.

[9] AEP Ohio Brief, pp. 13, 32 (with no citation, arguing that AEP Ohio has the "contractual right under the RAA to elect to pursue" cost-based pricing).

[10] AEP Ohio Brief, p. 14.

On November 24, 2010, American Electric Power Service Corporation (AEP) filed on behalf of [AEP Ohio] new rate schedules under Schedule 8.1 [of the RAA] to collect their respective capacity costs for meeting the capacity obligation of the PJM [RPM]. As discussed below, the Commission will reject the proposal as unauthorized under the RAA . . . .

Section D.8 of Schedule 8.1 of the RAA provides that a "state compensation mechanism will prevail" in allocating capacity costs to retail LSEs. In this case, the Ohio Commission has adopted such a state mechanism and we therefore reject the AEP Ohio Companies' filing.

The AEP Ohio Companies recognized in their initial filing that the absence of a state mechanism was a prerequisite to their filing, stating "Ohio has not established a compensation mechanism for capacity sales." It is uncontroverted that such a mechanism has now been adopted by the Ohio Commission, even if the parties disagree over whether such a mechanism existed on the date the AEP Ohio Companies submitted its filing.

The AEP Ohio Companies argue that the RAA expressly provides for making a section 205 filing to change the compensation mechanism. However, when read in context, the provision for making a section 205 filing applies only when no state compensation mechanism exists; the adverbial phrase in Section D.8 of Schedule 8.1 of the RAA, "in the absence of a state compensation mechanism," qualifies the remainder of that sentence and therefore conditions the right to make a section 205 filing. . . .

Since the PJM RAA does not permit AEP to change a state imposed allocation mechanism, and AEP is a signatory to the RAA and does not have the right to change the PJM RAA unilaterally through a section 205 filing, this section 205 filing is not the appropriate vehicle for challenging the justness and reasonableness of Section D.8 of Schedule 8.1 of the PJM RAA.

Therefore, **we find that, pursuant to the RAA, the AEP Ohio Companies are not permitted to submit their proposed formula rate, given the existence of a state compensation mechanism, and we will reject this filing**.[11]

[11] *See* American Electric Power Serv. Corp., 134 FERC ¶ 61,039 (2011) at ¶¶ 1, 8-10, 12-13 (emphasis added).

The FERC's decision is unequivocal and binding. AEP Ohio's omission is even more egregious in that, upon questioning from Commissioner Porter, AEP Ohio witness Horton agreed that AEP Ohio can seek a cost-based rate at FERC only in the absence of a state compensation mechanism.[12]

AEP Ohio's Brief also argues that one of the RAA's alleged "alternatives for pricing capacity provided to CRES providers" is "a method based on the FRR Entity's costs (a formula cost-based method)."[13] AEP Ohio's suggestion that the RAA provides for a "formula cost-based method" is not supported by any record evidence, and AEP Ohio does not cite to or rely upon any record evidence in making its assertions. To the contrary, FES witness Stoddard testified that references to "costs" in the RAA refer to the much lower avoidable costs.[14] Here, too, AEP Ohio's Brief is inconsistent with its own admissions; AEP Ohio witness Horton acknowledged that he could not identify any references to "embedded costs" in the RPM Tariff or the RAA.[15] Nowhere in the RAA does it authorize, as suggested by AEP Ohio, cost recovery using a "formula cost-based method."

Nothing in the RAA provides AEP Ohio with the "right" to recover its costs – or, more specifically, its formula-rate fully embedded costs – through the charges for capacity provided to CRES providers. The Commission previously established a state compensation mechanism and instituted this proceeding to further explore the proper state compensation mechanism for

[12] Tr. Vol. II, pp. 547-549. AEP Ohio's citation to RESA witness Ringenbach for the proposition that an FRR Entity has the option to establish a cost-based charge (AEP Ohio Brief, p. 12) also lacks any credibility in the face of the FERC decision and the testimony provided by FES witness Stoddard, who was a drafter of the RAA. *See* Stoddard Direct, p. 11. Ms. Ringenbach's testimony reflects that she lacks a basic understanding of the RAA and has only been aware that AEP Ohio was an FRR Entity since 2010. *See* Tr. Vol. IV, pp. 800-801. Thus, her testimony does not provide any support to AEP Ohio's argument.

[13] AEP Ohio Brief, p. 14.

[14] Stoddard Direct, p. 16.

[15] Tr. Vol. II, pp. 386-87; Stoddard Direct, p. 16.

shopping customers' capacity. As set forth in FES' Brief, a state compensation mechanism based on RPM market prices is supported by Ohio law, policy and economic principles.

B. AEP Ohio's Brief Provides No Valid Support In Law Or Policy For A Cost-Based State Compensation Mechanism.

1. AEP Ohio cannot change the fact that state law and policy favor a competitive, market-based price for generation service such as capacity.

As an initial point, it is worth noting AEP Ohio's acknowledgment regarding Intervenors' numerous policy arguments. In its Brief, AEP Ohio asserts that Intervenors "merely argue as a policy matter that RPM would be favorable to their interests."[16] Intervenors represent residential customers, low-income customers, commercial customers, industrial customers, schools, hospitals, restaurants, independent businesses, CRES providers, and generators. That the interests of all of these Intervenors are "merely" supported by the use of RPM prices is significant, and AEP Ohio's corresponding suggestion that its own interests override all others' is unavailing. State law and policy does not provide any support for AEP Ohio's proposition – nor does the record evidence or common sense.

a. RPM establishes the market price for capacity called for by Ohio's law requiring that generation service be competitive.

Ohio has a competitive market for electric generation service, and a market warrants market pricing.[17] AEP Ohio's election as a FRR Entity, whereby it used its status to become the monopoly provider of capacity in its territory, cannot change Ohio law. In fact, as recently as November 2011 -- four years after it made its FRR election -- AEP has acknowledged that "the Ohio companies generation assets are not cost-based rate regulated."[18] Thus, despite the fact

[16] AEP Ohio Brief, p. 24.

[17] *See* R.C. § 4928.03.

[18] IEU Ex. 124, Nov. 4, 2011 AEP Memorandum, "ASC 360 - Cross-State Air Pollution Rule: Recoverability Test -- East Fleet," at p. 2.

that AEP Ohio is the sole source for capacity in its zone, RPM market pricing is the only proper pricing for capacity provided to CRES providers. In order to get out from under this obvious connection between RPM market pricing and Ohio's market for generation service, AEP Ohio attempts to re-characterize the RPM auction results as regulated prices.[19] In doing so, AEP Ohio completely misrepresents FES witness Stoddard's testimony.[20] Mr. Stoddard clearly testified that RPM prices are representative of an open, competitive market. In fact, in response to AEP Ohio's counsel's attempts to distort Mr. Stoddard's direct testimony, Mr. Stoddard responded that:

> As a general summary, while I will accept there are a lot of regulations that govern how this market operates, all important markets, for instance the stock market, has a big pile of regulations about how it operates. Any important market needs to have those regulations in hand, and there is an important part of the market which remains unregulated. These offers from new supply, offers from imports, offers from demand side resources that keep the market in touch with the actual supply conditions and demand conditions of the market. . . .
>
> [M]any, many markets, in fact, arguably, all important markets, are subject to important regulation. It doesn't change the fact that effective markets, and FERC has, in approving these regulations, have determined these are the just and reasonable way for setting a reasonable price for capacity. . . .
>
> [RPM] includes many regulatory checks and balances, but, at the core of it, it is a market of willing sellers offering resources into a market set where the quantity is set to meet the reliability needs of the region.[21]

[19] AEP Ohio Brief, pp. 34-35.

[20] AEP Ohio Brief, p. 34.

[21] Tr. Vol. VIII, pp. 1601-1603. The regulations which govern market operation are appropriate due to the small number of suppliers and the potential for inappropriate market power. Stoddard Direct, pp. 11-12.

AEP Ohio has no probative evidence on which to discredit the competitive results of the RPM BRA market framework that has been approved by the FERC and that is used to set capacity prices in every zone of PJM.

AEP Ohio also attempts to re-characterize the "significance" of its decision to become an FRR Entity and to distinguish itself from CRES providers.[22] AEP Ohio asserts that AEP Ohio does not have the same "advantages and flexibilities in power supply and pricing" as do CRES providers.[23] However, this argument again ignores the fact that it was AEP Ohio's decision to take on the FRR requirement when generation service was competitive. More importantly, this is not the correct comparison. AEP Ohio had the option of the FRR election or *participation in the BRA*. AEP Ohio did not have the choice to become a CRES provider as part of its FRR election. As Mr. Stoddard explained in great detail at hearing, there is almost no practical difference between the FRR election and participation in the BRA for generators.[24] Under either election the generator is subject to the exact same obligations under the PJM tariff, is required to comply with the exact same testing requirements, and is subject to the exact same penalties for non-compliance with reliability standards.[25] As there is no practical difference between these two elections, there are no substantive "advantages and flexibilities" associated with AEP Ohio's FRR election. AEP Ohio should not be able to avoid the impact of its own decision to preclude itself from the flexibility associated with the competitive market and should not be allowed to push that impact onto retail customers or CRES providers.

[22] AEP Ohio Brief, pp. 24-25.

[23] AEP Ohio Brief, p. 24.

[24] Tr. Vol. VIII, pp. 1606-08.

[25] Tr. Vol. VIII, p. 1607.

b. AEP Ohio's proposed above-market capacity pricing does not serve to ensure the availability of adequate, reliable, or reasonably priced retail electric service.

AEP Ohio argues that a capacity price that is four times higher than the market price furthers the state's policy of "ensur[ing] the availability to consumers of adequate, reliable, safe, efficient, nondiscriminatory, and reasonably priced retail electric service."[26] Based on numerous Intervenor briefs, it is clear that AEP Ohio's customers do not agree that the $355/MW-day capacity price and its limitations on their ability to access the competitive market promote "reasonably priced" retail electric service.[27] Indeed, and as further discussed below, the bases for AEP Ohio's argument in this regard were rejected by numerous witnesses, including AEP Ohio's own experts, and are otherwise unsupported by any probative evidence.[28]

i. The $355/MW-day capacity price is neither appropriate nor necessary to encourage generation investments.

AEP Ohio argues that embedded cost recovery will "encourage investment in generation in Ohio and thereby increase retail reliability and affordability."[29] AEP Ohio itself mooted this argument when it acknowledged that "AEP Ohio is not planning to build significant new generation prior to 2015," at which time it will be a participant in the RPM BRA process and subject to RPM prices.[30] This argument also was soundly rebutted by AEP Ohio's and FES' experts, who testified that PJM's RPM construct is working well to incentivize the appropriate generation investments. AEP Ohio witness Eugene Meehan wrote that "price signals are more accurate within competitive markets, and can stimulate appropriate infrastructure investment"

[26] R.C. § 4928.02(A); AEP Ohio Brief, pp. 19-20.

[27] *See* IEU Brief, pp. 50-59; OCC Brief, pp. 11-14; OMA/OHA Brief, pp. 17-21; OEG Brief, pp. 5-6; Kroger Brief, pp. 2-3; Schools Brief, pp. 5-8; NFIB Brief, pp. 2-3.

[28] *See infra*, Section II(B)(1)(b)(i).

[29] AEP Ohio Brief, p. 20.

[30] AEP Ohio Brief, p. 22.

and that "competitive markets are widely held to produce the most efficient results in our economy, providing the lowest costs to customers."[31] AEP Ohio witness Frank Graves testified that RPM has done a good job of incentivizing the construction of new capacity and that PJM (including the AEP Ohio zone) is currently long on capacity – with 13 GW of excess capacity currently and an additional 5-9 GW expected in the next few years.[32] His Brattle Group also reported that, "[d]espite concerns by some stakeholders, RPM has been successful in attracting and retaining cost-effective capacity sufficient to meet resource adequacy requirements" and that RPM "has also facilitated decisions regarding the economic tradeoffs between investment in environmental retrofits on aging coal plants or their retirement."[33] Mr. Stoddard also rebutted AEP Ohio's suggestion that RPM attracts the "wrong" type of resources because the RPM process is working and has led to more than 28,000 MW of new resources.[34] Thus, the overwhelming evidence establishes that RPM pricing is the mechanism that is designed to and has proven to provide the appropriate incentives for economic generation investments.

ii. The $355/MW-day capacity price is unrelated to AEP Ohio's self-imposed FRR "burden."

AEP Ohio also argues that it is entitled to a cost-based rate for its "obligations as an FRR entity" and because AEP Ohio's assets are "dedicated to Ohio."[35] Neither is true. AEP Ohio's FRR "obligation," of course, is a "burden" of its own making. It elected the FRR option voluntarily while operating in a competitive market[36] and it did so with the other AEP East

[31] IEU Ex. 125, p. 1, 6

[32] Tr. Vol. V, pp. 869-71.

[33] Stoddard Direct, Ex. RBS-6, p. I

[34] Stoddard Direct, pp. 50-51. Mr. Graves does not identify which resources he considers to be the current "right" type of resources, but even AEP Ohio is not seeking to construct more coal facilities.

[35] AEP Ohio Brief, pp. 20-21.

[36] Stoddard Direct, p. 9.

operating companies because they believed the FRR election would be better for them than participating in the BRA.[37] Simply because the FRR election is no longer beneficial does not turn AEP Ohio's FRR status into anything more than the fulfillment of its voluntary agreement to provide capacity, as explained further in Section II(A).

FES' Brief also refuted AEP Ohio's assertion that its assets are dedicated to Ohio. The FRR election was made by the AEP East entities, collectively, and draws on all of the AEP East assets.[38] The AEP East entities include more than just AEP Ohio. AEP Ohio has not dedicated any capacity to Ohio customers. In fact, AEP Ohio's own internal memorandum acknowledges that:

> The non-cost based rate generation assets are not operated separately, but are coordinated with the generation assets owned by the other East cost-based regulated operating companies. . . . Due to the nature of electrical energy and the operation of the plants through the Pool, it is impossible to match cash inflows from the sales to cash outflows from either purchased or generated power by unit or by plant.[39]

AEP Ohio has not presented evidence of the costs of the assets that actually are being used to serve customers in AEP Ohio's service territory. Thus, a formula rate tied to AEP Ohio's assets is inappropriate, and AEP Ohio's voluntary FRR election does not justify guaranteed cost recovery.

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[37] Tr. Vol. II, p. 396.

[38] Stoddard Direct, p. 9.

[39] IEU Ex. 124, Nov. 4, 2011 AEP Memorandum, "ASC 360 - Cross-State Air Pollution Rule: Recoverability Test -- East Fleet" at p. 3.

c. AEP Ohio has provided no evidence of "financial harm" or the need for emergency rate relief.

AEP Ohio's Brief continues to assert a vague "financial harm" that may occur if it charges the same RPM price that every other capacity supplier in PJM charges for capacity.[40] But, as set forth in FES' Brief, there is no probative evidence of any such harm. Of course, the determination of AEP Ohio's proposed capacity pricing is guided by any legal or other standard based on "financial harm." Regardless, it would violate state law and policy for AEP Ohio to be guaranteed any rate of return for electric generation service. AEP Ohio and all other generators providing service to Ohio customers are subject to the competitive market that – specifically because the market does not guarantee any rates of return – incentivizes the most economic investments and promotes lower prices. Second, AEP Ohio's only purported evidence of "financial harm" – Mr. Allen's return on equity analysis – is flawed and fails to establish any real harm that warrants the Commission's intervention. When corrected, Mr. Allen's analysis reflects that AEP Ohio's proposed capacity charge would allow it to earn an ROE of 13.4% in 2012 and 13.7% in 2013.[41] AEP Ohio off-handedly suggests that RPM prices would be "confiscatory" to AEP Ohio.[42] But, as pointed out by the Ohio Manufacturers' Association and the Ohio Hospital Association, AEP Ohio has come nowhere near the required showing that such prices – which are paid to all other PJM suppliers – are confiscatory.[43]

Mr. Allen's analysis relies on unrealistic shopping assumptions that artificially lower his results. Despite the fact that AEP Ohio has had the lowest shopping rates in the state since the start of the competitive market, Mr. Allen now believes that AEP Ohio, within the next twelve

[40] *See* AEP Ohio Brief, pp. 20-21.

[41] FES Ex. 122 (Scenario 2).

[42] AEP Ohio Brief, p. 21.

[43] *See* OMA/OHA Brief, pp. 13-17.

months and under above-market capacity pricing, will have the second highest residential shopping in the state and double the state average.[44] This assumption is unsupported by reason and lacks credibility. Thus, Mr. Allen's analyses should be disregarded.

Furthermore, if AEP Ohio has legitimate concerns about its financial stability, it has other statutory options to seek relief that would not necessarily disrupt the competitive market. For example, if AEP Ohio has a distribution revenue issue affecting reliability, it can file a distribution rate case.[45] Any distribution-related issues should be considered separate and apart from AEP Ohio's generation-related requests here because of Ohio law's mandate for corporate separation.[46] In addition, AEP Ohio could seek emergency rate relief under R.C. § 4909.16. To do so, AEP Ohio must prove with clear and convincing evidence that, absent such extraordinary emergency relief, it will be financially imperiled or its ability to render service will be impaired.[47] If and only if AEP Ohio makes that showing, which has been established through expert testimony in the past, then the Commission could grant temporary relief only at the "minimum level necessary to avert or relieve the emergency."[48] AEP Ohio has not met this standard, and its unsupported request for above-market capacity pricing cannot serve as an end-run around these statutory procedures.

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[44] Tr. Vol. III, p. 592; FES Ex. 102, Direct Testimony of Tony C. Banks, filed Apr. 4, 2012 ("Banks Direct"), p. 11.

[45] *See* FES Brief, pp. 26-27.

[46] R.C. §§ 4928.03, 4928.17.

[47] *In re Akron Thermal, Ltd. Partnership*, Case No. 00-2260-HT-AEM, Opinion and Order at p. 3 (Jan. 25, 2001).

[48] *Id.*

2. There is no probative evidence that suggests that AEP Ohio's $355/MW-day capacity price, which is four times higher than market, "promotes" competition.

AEP Ohio does not, and cannot, challenge the benefits of competition. Numerous witnesses, including AEP Ohio's experts, thoroughly established that competition benefits customers by promoting efficiencies and lower prices.[49] As echoed by the FERC, "competitive market mechanisms provide important economic advantages to electricity customers in comparison with cost of service regulation," including that competition among suppliers "keeps prices as low as possible."[50]

Because it cannot dispute the benefits of competition, AEP Ohio suggests that the competition that would result from the well-established RPM pricing is "artificial."[51] AEP Ohio's Brief contains no explanation as to what it means by "artificial" competition or how "artificial" competition might harm customers. Instead AEP Ohio's Brief contains a number of misrepresentations and omissions regarding the impact of the proposed $355/MW-day capacity price on the competitive market in its service territory.

AEP Ohio's argument that the proposed $355/MW-day price actively promotes competition is not supported by any credible evidence. AEP Ohio relies almost exclusively on its witness, William Allen, as its source for evidence regarding CRES pricing and headroom.[52] Mr. Allen is not familiar with the "interworkings [sic] of how a CRES operates," has only become more involved with CRES providers in the last 8-10 months and has had no discussions

[49] *See* FES Brief, pp. 12-20.

[50] FES Ex. 118 at ¶ 32 *quoting* 117 FERC ¶ 61,331, Dec. 22 Order, at ¶ 141.

[51] AEP Ohio Brief, p. 19.

[52] *See* AEP Ohio Brief, pp. 16-17.

with CRES providers regarding marketing.[53] AEP Ohio cites Mr. Allen's statement that CRES providers' will have a 13% gross margin under a $355/MW-day capacity price in support of its position.[54] But, Mr. Allen did not provide any direct testimony or workpapers on this point; his off-hand reference on the stand was convenient, but wholly unsupported and likely represents another "thought exercise." He also admitted that he does not know what impact it would have on shopping if the capacity price moves from $20 to $355/MW-day.[55]

The credible witnesses with CRES experience uniformly agreed that the proposed $355/MW-day price would negatively impact competition. Under such a capacity price, customers would not receive the benefits of competition either because CRES providers would be unable to offer savings to customers and/or would have to pass higher costs on to customers:

Constellation / Exelon witness Fein

> "At [the $355/MW-day] level, I do not believe we would be able to make offers that would be viewed as attractive by customers."[56]

IGS witness Hamman

> If CRES providers were required to pay above-market capacity prices, "[g]oing forward that would have a drastic impact on the . . . competitive market. The pricing would have to take that higher cost into effect and we would pass through to the rates that customers would be shown in the market."[57] Indeed, "CRES

[53] *See* AEP Ohio Brief, p. 32 (acknowledging that AEP Ohio initiated this proceeding in 2010 "shortly after shopping began in earnest in the AEP Ohio service territory" and that "AEP Ohio had no reason to pursue its cost-based election . . . prior to 2010 because the amount of shopping at that time was insignificant") *citing* AEP Ohio witness Munczinski.

[54] *See* AEP Ohio Brief, p. 17.

[55] Tr. Vol. XI, pp. 2405-2406.

[56] Tr. Vol. VIII (Fein), p. 1564;; *see also* NFIB Ex. 101, Direct Testimony of Roger R. Geiger, filed Apr. 4, 2012 ("Geiger Direct"), p. 5 (even at $255/MW-day, competition would be harmed).

[57] Tr. Vol. IV, p. 784 (IGS witness Hamman); *see also* Frye Direct, p. 9 (approving the $355/MW-day capacity price could cause CRES providers to trigger the "regulatory provision" contained in many contracts, which would pass through the increased costs to customers).

> suppliers would have to charge higher rates for service or be prevented from entering the market altogether."[58]

FES witness Banks

> "In this proceeding if we were required to pay a capacity charge [of $355/MW-day], then FES would always honor its contracts, but in this case we would lose money.[59]

RESA / Direct Energy witness Ringenbach

> "If AEP is granted their request to receive $355/MW-day for capacity, all shopping customers, including schools, small commercial customers, and those in governmental aggregation, would see an immediate increase in their electric bills and may be forced to break their contract with the CRES."[60]

AEP Ohio's failure to cite or even acknowledge the overwhelming testimony regarding the negative impact of the proposed $355/MW-day price on competition misrepresents the record evidence. AEP Ohio's argument that RPM pricing "would not foster efficient or durable competition"[61] similarly lacks any credibility. RPM pricing is used in every other EDU territory in Ohio – all of which have experienced much more competition than AEP Ohio and whose customers have enjoyed significant savings.[62] FES witness Banks also refuted AEP Ohio's repeated attempts to portray CRES providers as greedy middlemen who would retain any decrease in capacity prices for themselves, which reveals AEP Ohio's lack of understanding of the competitive market.

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[58] Hamman Direct, p. 5.

[59] Tr. Vol. VIII, p. 1688. Mr. Banks further explained that: "The customer knows that [FES has the right to terminate its contracts], and we went into the contract with that understanding with the customer." Tr. Vol. VIII, p. 1705-1706.

[60] Ringenbach Direct, p. 19.

[61] AEP Ohio Brief, p. 18.

[62] Stoddard Direct, pp. 19-20.

> [I]f you really have been in the competitive markets, you learn to understand that any price that a CRES provider offers, to the extent there's competition, it's subject to competition from other suppliers.
>
> So if a CRES provider got a discount on anything that was readily available in the marketplace, the CRES provider is going to have to pass those savings on to customers; otherwise, they risk losing those customers.[63]

FES agrees with AEP Ohio that the "focus should be on fair and balanced competition."[64] But, guaranteeing one generation competitor fully embedded cost recovery at a level four times higher than the market prices to which all other generators are subject is neither fair nor balanced. The Commission simply cannot ensure that the state's policy to promote a competitive market for electric generation service is effectuated, as it is required to do under Ohio law,[65] if it approves AEP Ohio's proposed $355/MW-day capacity price.

3. The $355/MW-day capacity price only favors AEP Ohio, and the Commission should not allow an improper subsidy toAEP Ohio's affiliates.

AEP Ohio continues to argue that the RPM-based prices that it has charged for years (and that it proposes to charge again in the future) and that are used to price capacity in every other EDU's service territory would subsidize CRES providers or SSO customers.[66] In its brief, it also

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[63] Tr. Vol. VIII, pp. 1660-1661; *see also* Tr. Vol. pp. 836-37 (RESA witness Ringenbach testifying that CRES providers will compete amongst themselves to ensure the AEP Ohio's customers receive the benefit of market-based capacity pricing).

[64] AEP Ohio Brief, p. 17.

[65] *See* R.C. § 4928.06(A) ("Beginning on the starting date of competitive retail electric service, **the public utilities commission shall ensure that the policy specified in section 4928.02 of the Revised Code is effectuated**.") (emphasis added); R.C. § 4928.02(H) (setting forth the state's policy to "Ensure effective competition in the provision of retail electric service . . . "); *see also* R.C. § 4928.06(A), (C), (E)(1) (requiring the Commission to "monitor and evaluate the provision of retail electric service in this state. . . for the purpose of discerning any competitive retail electric service that is no longer subject to effective competition" and to "exercise [its] authority, to resolve abuses of market power by any electric utility that interfere with effective competition in the provision of retail electric service").

[66] *See* AEP Ohio Brief, pp. 29-31.

suggests that RPM-based prices would disadvantage other members of the AEP Pool and AEP Ohio's SSO customers.[67] Neither argument is valid nor a legitimate basis for the Commission to deviate from reliability-ensuring purpose of the RPM.

First, AEP Ohio's affiliates are free to contract as they see fit and as is appropriate under their respective regulatory structures, but they cannot contract in such a way as to relieve AEP Ohio from the requirements of Ohio law and policy or to alleviate AEP Ohio's obligations to its Ohio customers. Nor should abstract allegations lead the Commission to ignore the legal, policy, and economic implications of capacity prices based on fully embedded costs. AEP Ohio's assertions continue to reflect an ignorance (or an avoidance) of the goals of PJM's RPM, which the FERC has approved as just and reasonable and has found will provide economic benefits to customers.[68] Under the RPM, of which the FRR alternative is a part, the capacity pricing determined by the market is, by definition, the just and reasonable price for ensuring reliability.

AEP Ohio's arguments regarding discrimination against SSO customers also fail. Generation is a competitive service in Ohio. If AEP Ohio wants to increase its base generation rate so as to recover revenue from SSO customers equal to its fully embedded costs, it can do so provided its SSO is more favorable in the aggregate than an MRO. But CRES providers are not required to pay AEP Ohio's fully embedded costs, simply because AEP Ohio wants to recover them. Further, as Mr. Stoddard testified, "charging the proper price to one customer does not result in harm to another customer."[69] In other words, it is not a subsidy or a "discount" to charge the going market rate. The competitive market exists to, among other things, challenge AEP Ohio and CRES providers to reduce their rates, to the benefit of customers.

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[67] AEP Ohio Brief, pp. 26-27.

[68] *Id.* at ¶ 32 *quoting* 117 FERC ¶ 61,331, Dec. 22 Order, at ¶ 141 (emphasis added).

[69] Stoddard Direct, p. 22.

AEP Ohio's proposed $355/MW-day capacity price would provide AEP Ohio with an additional revenue stream not available to competitive suppliers and, thus, subsidize AEP Ohio's competitive services on the backs of shopping customers.[70] Generation owners, including some CRES suppliers, in the rest of the PJM unconstrained market will receive only RPM market-based prices for their capacity and, thus, should not be disadvantaged by AEP Ohio's unilateral decision to pull itself out of the market and to seek fully embedded cost recovery. As explained by FES witness Stoddard:

> Allowing AEP Ohio to charge the RPM RTO rate puts it in exactly the same position as every other generation supplier in PJM: earning the RPM price, with whatever margins are implied by that rate. Independent power producers certainly have no means to require purchasers to buy capacity at embedded costs, and I am unaware of any other utility in PJM that has the ability to require shopping customers to pay its embedded costs.[71]

AEP Ohio admitted on cross-examination that the above-market revenue would allow it to subsidize both its competitive generation and non-competitive distribution services[72] – a subsidy that AEP Ohio proposes to continue, despite its egregiousness, after corporate separation.[73] AEP Ohio's proposed above-market capacity pricing is improper and contrary to Ohio law requiring corporate separation and Ohio's policy to "avoid[] anticompetitive subsidies flowing from a noncompetitive retail electric service to a competitive retail electric service . . . and vice versa."[74]

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[70] Banks Direct, p. 14; Tr. Vol. IV, pp. 786-787 (IGS witness Hamman); *see also* Hamman Direct, p. 5 (To require CRES suppliers to pay any more for the market capacity would be artificially subsidizing AEP [Ohio].").

[71] Stoddard Direct, p. 23.

[72] Tr. Vol. I, p. 33-35, 79.

[73] Tr. Vol. I, pp. 41-42; Lesser Direct, p. 15.

[74] R.C. §§ 4928.17, 4928.02(H).

4. An RPM-priced state compensation mechanism is the only fair pricing given AEP Ohio's "bait and switch."

AEP Ohio somehow suggests that CRES providers are to blame for the fact that AEP Ohio seeks to change the pricing mechanism for capacity in its service territory, and goes so far as to state that "AEP Ohio should not now be penalized for CRES providers' failure to manage the price of their capacity input."[75] AEP Ohio cannot change the facts – and the facts are that AEP Ohio is engaged in a classic bait-and-switch. AEP Ohio has consistently charged RPM prices for capacity, and its request to radically change its capacity pricing methodology was timed such that CRES providers had no ability to manage their capacity input.[76]

- Starting in 2007 after its FRR election, AEP Ohio charged RPM prices for capacity provided to CRES providers.[77]

- In 2008, AEP Ohio offered testimony arguing that RPM prices were the appropriate price for capacity.[78]

- In May 2009, AEP Ohio elected to file an FRR plan for the 2012/13 Planning Year at a time when the default pricing for capacity was RPM pricing. Prior to locking out the self-supply option for CRES providers by filing this plan, AEP Ohio gave no notice to CRES providers that it would seek an extreme price increase more than one year later.

- In May 2010, AEP Ohio again elected to file an FRR plan, this time for the 2013/14 Planning Year. Again, prior to locking out the self-supply option for CRES providers, AEP Ohio gave no notice that it would seek an extreme price increase later that year.[79]

- It was not until November 2010 that AEP Ohio first indicated that it wanted to increase its capacity charges to CRES providers by switching to a full-embedded-cost methodology.

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[75] *See* AEP Ohio Brief, p. 33.

[76] *See* Stoddard Direct, pp. 42-43.

[77] Munczinski Direct, pp. 5-6.

[78] Stoddard Direct, p. 43 (citing Direct Testimony of Craig Baker on behalf of CSP and OPCo, Case No. 08-918-EL-SSO, p. 11).

[79] *See* Tr. Vol. I, pp. 92-93.

- As of November 2010, CRES providers could not elect to self-supply capacity in AEP Ohio's service territory until the 2014/15 Planning Year, which election must have been made by May 2011.[80]

- On December 8, 2010, the Commission re-affirmed that the state compensation mechanism should be based on RPM pricing, and the FERC confirmed in January 2011 that this state compensation mechanism preempted AEP Ohio's request for a cost-based rate.[81]

- In May 2011, AEP Ohio again elected to file an FRR plan for the 2014/15 Planning Year. The most rational response for CRES providers, given the Commission's entry re-affirming the state compensation mechanism, was to continue to operate under AEP Ohio's FRR plan.[82]

- AEP Ohio will complete its Pool termination and corporate separation on or before January 1, 2014, i.e., in the middle of the 2013/14 Planning Year, and thereby be obligated to its customers to obtain market-based capacity pricing.[83]

Based on these undisputed facts, CRES providers reasonably relied on receiving RPM-based capacity pricing through the 2014/15 Planning Year. Even AEP Ohio witness Graves admitted that CRES providers would have had no incentive to elect into AEP Ohio's FRR plan due to AEP Ohio's historic use of RPM pricing.[84] Moreover, CRES providers do not have the ability to make their own FRR election or to supply their own capacity prior to May 31, 2015.[85] Starting January 1, 2014, however, and as discussed further in Section II(C), *infra*, a requirement that CRES providers should pay AEP Ohio's competitive affiliate a cost-based, above-market capacity price would be illegal and improper.

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[80] Stoddard Direct, p. 43.

[81] Stoddard Direct, pp. 43-44; Order Rejecting Formula Rate Proposal, FERC Case No. ER11-2183-000, ¶¶ 8, 12 (Jan. 20, 2011).

[82] Stoddard Direct, p. 44.

[83] Tr. Vol. II, pp. 277-80; *infra*, Section II(c).

[84] Tr. Vol. V, p. 886.

[85] Stoddard Direct, pp. 42-44; Tr. Vol. I, pp. 72-73 (AEP Ohio witness Munczinski stating that AEP Ohio will not allow CRES providers to self-supply capacity prior to June 1, 2015).

Changing the rules of the game at this late date is nothing more than a "bait and switch."[86] The "bait" is the historic use of RPM prices, removing any incentive for CRES providers to supply their own capacity into AEP's FRR plan. The "switch" is the unilateral attempt to charge embedded costs. AEP Ohio chose to make this change after the date for making the self-supply election has passed, thereby exploiting AEP Ohio's monopoly power.[87] Thus, basic principles of fairness also support a state compensation mechanism that continues the use of RPM-based pricing for capacity.

C. Cost-Based Pricing Post-Corporate Separation Is An Improper Cross-Subsidy That Violates FERC Affiliate Pricing Rules.

After corporate separation on January 1, 2014, AEP Ohio does not intend to go to market to purchase capacity.[88] AEP Ohio assumes that it should pay AEP Generation Resources the above-market $355/MW-day price for capacity during the bridge period.[89] This would be an improper cross-subsidy by AEP Ohio customers of a competitive affiliate, since there is no market basis for this price. Instead, it is merely the price AEP seeks to impose as a result of FRR monopoly power. This proposal violates well-established FERC policy and should be rejected by the Commission.

Under FERC guidelines, no wholesale sale of electric energy or capacity may be made between a franchised public utility with captive customers and a market-regulated power sales affiliate without first receiving FERC authorization for the transaction under section 205 of the

[86] Stoddard Direct, p. 45.

[87] Stoddard Direct, p. 45.

[88] Tr. Vol. I, p. 42.

[89] FES Brief, p. 60, Tr. Vol. I, pp. 41-42.

Federal Power Act.[90] FERC requires pre-approval of these sales because a public utility with captive customers could potentially interact with market-regulated power sales affiliates in ways that transfer benefits to the affiliates and their stockholders to the detriment of captive customers.[91] In affiliate cases "the mere opportunity" for affiliate abuse will lead to FERC rejection of the proposed agreement.[92]

FERC's standard for reviewing these agreements is provided in the *Edgar* decision.[93] In brief, there are three approaches to demonstrate that a utility (such as AEP Ohio) has chosen the lowest-cost supplier and, thus, that it has not unduly preferred its affiliate supplier (the GenCo). First, the utility may submit evidence of direct head-to-head competition between affiliated and non-affiliated suppliers either in a formal solicitation or in an informal negotiation process.[94] Second, the utility may present evidence of the prices that non-affiliated buyers were willing to pay for similar services from that project.[95] Finally, the utility may provide "benchmark" evidence of the prices, terms and conditions of sales by non-affiliated sellers, also known as the market price.[96]

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[90] Tr. Vol. I, p. 38; *Duke Energy Indiana Inc.*, 136 FERC P 61001, 2011 WL 2644369, p. *2 (FERC 2011).

[91] *Duke Energy Indiana Inc.*, 136 FERC P 61001, 2011 WL 2644369, p. *2 (FERC 2011).

[92] *Boston Edison Company Re: Edgar Electric Energy Company*, 55 FERC P 61382, 1991 WL 266200, *8 (FERC 1991) (hereinafter, "*Edgar*").

[93] *Boston Edison Company Re: Edgar Electric Energy Company*, 55 FERC P 61382, 1991 WL 266200 (FERC 1991). *See Duke Energy Indiana Inc.*, 136 FERC P 61001, 2011 WL 2644369, p. *3 (FERC 2011).

[94] *Boston Edison Company Re: Edgar Electric Energy Company*, 55 FERC P 61382, 1991 WL 266200, *8 (FERC 1991); *Duke Energy Indiana Inc.*, 136 FERC P 61001, 2011 WL 2644369, p. *3 (FERC 2011).

[95] *Boston Edison Company Re: Edgar Electric Energy Company*, 55 FERC P 61382, 1991 WL 266200, *9 (FERC 1991); *Duke Energy Indiana Inc.*, 136 FERC P 61001, 2011 WL 2644369, p. *3 (FERC 2011).

[96] *Boston Edison Company Re: Edgar Electric Energy Company*, 55 FERC P 61382, 1991 WL 266200, *9 (FERC 1991); *Duke Energy Indiana Inc.*, 136 FERC P 61001, 2011 WL 2644369, p. *3 (FERC 2011).

AEP Ohio has met none of these criteria in this case, and it cannot do so. Indeed, it has affirmatively represented that it will not do so.[97] Its pricing proposal after corporate separation is to purchase all the capacity it needs from the GenCo at the $355/MW-day "cost" based rate. There has been no bidding or competition to provide this capacity. There is no evidence that any other EDU besides AEP Ohio would be willing to pay dramatically above-market rates for capacity for the 2013/14 and 2014/15 Planning Years. There is no evidence of similar sales in the marketplace for these planning years. AEP Ohio has not, and cannot, meet any of the *Edgar* criteria. Thus, AEP Ohio's proposed $355/MW-day capacity price following corporate separation clearly violates FERC rules.

The state compensation mechanism is a product of a FERC tariff – the RAA – and, thus, should not violate FERC rules. As a result, the Commission should reject AEP Ohio's proposed capacity pricing as an improper cross-subsidy to its affiliated GenCo in violation of FERC rules.

D. AEP Ohio Has Incorrectly Calculated Its Costs.

1. Mr. Pearce's Formula Rate Is Invalid.

a. AEP Ohio's Proposed Capacity Pricing Formula Has Not Been Approved By FERC And Is Not Entitled To Any Deference.

AEP Ohio repeatedly claims that its "formula" has been subject to "heavy regulatory review" by FERC and is therefore entitled to deference.[98] This is incorrect. The FERC formula used by Mr. Pearce involved contracts with customers who purchased both capacity and energy from the AEP Affiliate.[99] However, in this case AEP Ohio proposes to sell only capacity at its

[97] Tr. Vol. I, pp. 39-40, 42. AEP Ohio witness Munczinski testified that he was not aware of the standards the FERC would use to review the contract between AEP Ohio and the GenCo. Tr. Vol. I, p. 108.

[98] AEP Ohio Brief, p. 38; *see also*, AEP Ohio Brief, p. 4 ("Notably, FERC itself has previously approved the template utilized by Dr. Pearce."); AEP Ohio Brief, p. 39 (referencing "the FERC-approved Minden/Prescott template.")

[99] Tr. Vol. II, pp. 249-50.

"cost" while selling energy at market prices. FERC has never approved this formula rate for a customer purchasing only capacity, for good reason.[100] AEP Ohio's proposed rate would force customers to pay above-market cost-based prices for capacity while at the same time being forced to pay market prices (which are higher than cost-based prices) for energy. This is unfair and discriminatory, and has not been approved by the FERC. AEP Ohio's "regulatory review" argument also fails because these settlement agreements specifically stated that they were not to be regarded as precedent in any other proceeding.[101] The settlement agreements should be accorded no precedential value by the Commission.

b. AEP Ohio's proposed rate improperly includes the full-embedded costs of all of AEP Ohio's generation, rather than the "to go" costs of generation actually used by Ohio customers.

AEP Ohio's formula rate is based on the full embedded cost of its generation assets. This is inappropriate because the RAA only provides the opportunity to recover avoidable "to go" costs as an incentive to ensure reliability.[102] AEP Ohio claims that its full embedded cost approach is appropriate because it reflects the actual costs incurred by AEP Ohio, but the RPM is a construct that is not designed to recover full embedded costs.[103] Calculating a rate based on full embedded costs dramatically overstates AEP Ohio's true value of capacity under the RAA, which limits offers to "to go" costs.[104] AEP Ohio admits that the concept of "embedded costs" is nowhere to be found in the RAA, which instead makes numerous references to "avoidable

[100] Tr. Vol. II, pp. 252-53.

[101] Tr. Vol. II, p. 251.

[102] AEP Ohio Brief, p. 36; Tr. Vol. VIII, pp. 1598-1600.

[103] AEP Ohio Brief, p. 36; Tr. Vol. VIII, pp. 1598-1600. "All load-serving entities in the PJM footprint are part of the RPM design. There are two different ways that such an entity will meet those obligations, either through the auction or through the FRR alternative." Tr. Vol. VIII, p. 1593. Thus, the FRR election does not exempt AEP Ohio from the RPM design.

[104] FES Brief, p. 29.

costs."[105] Under a market construct, generation owners recover their costs through energy prices, and the RPM and the RAA set the value of capacity to the extent required to ensure reliability, not to recover full embedded costs.[106]

FES witness Stoddard examined the maximum offer price for each resource included in the AEP Ohio FRR capacity plan using the RAA's "to go" cost structure.[107] AEP Ohio's FRR portfolio has an overall negative net capacity cost of ($51.05/MW-day).[108] In other words, AEP Ohio is made whole with energy revenues even if the capacity rate charged to CRES providers is zero because its operating revenues will exceed operating costs. This implies that a unit would earn a contribution margin from energy sales even if it received no capacity payment at all.[109] Of course, when participating in the RPM market, a unit with a negative ACR would receive the RPM clearing price, thereby recovering all of its "to go" costs and a portion of its fixed costs.

c. AEP Ohio's calculation is incorrect because it includes costs that AEP Ohio is prohibited from recovering.

AEP Ohio does not dispute that its proposed formula rate includes investment after January 1, 2001 and stranded costs.[110] Instead, AEP Ohio claims that it should be permitted to recover these costs despite Ohio law and its own commitments to the contrary. There is no justification for this departure from Ohio law. The Commission does not have authority to grant recovery of these costs, and AEP Ohio is prohibited from recovering generation plant investment other than through market pricing after January 1, 2001.

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[105] Tr. Vol. II, pp. 386-87; Stoddard Direct, p. 16.

[106] Tr. Vol. VIII, pp. 1600-01.

[107] FES Brief, p. 33.

[108] Stoddard Direct, p. 34.

[109] Stoddard Direct, p. 35.

[110] AEP Ohio Brief, pp. 94, 103-13.

Under S.B. 3, all generation plant investment after January 1, 2001 was to be recovered solely in the market.[111] AEP Ohio claims that the provisions of S.B. 3 do not bar it from recovering post-2000 investment because this proceeding seeks to establish a wholesale, as opposed to retail, charge.[112] There is no statutory support for this argument, because S.B. 3 was not artificially limited to only retail charges directly billed to customers. Instead, S.B. 3 created competition for retail electric service starting on January 1, 2001.[113] After that date, "the utility shall be fully on its own in the competitive market."[114] There is no exception in S.B. 3 or S.B. 221 for cost-based recovery of post-2000 generation assets simply because capacity provided to non-SSO load is billed to CRES providers, who then include it in the costs passed on to customers.[115] There is no justification for ignoring S.B. 3 and imposing a massive generation cost increase on captive customers because capacity is purportedly a "wholesale" charge. Accordingly, AEP Ohio's post-2000 investment should be removed from Dr. Pearce's formula rate.

AEP Ohio attempts to justify its requested recovery of post-2000 investment by claiming that had it not invested in environmental compliance, those plants would not have been able to

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[111] R.C. § 4928.01(A)(28); R.C. § 4928.38 ("the utility shall be fully on its own in the competitive market."); Lesser Direct, p. 10.

[112] AEP Ohio Brief, p. 104.

[113] R.C. § 4928.01(A)(28); *Migden-Ostrander v. Pub. Util. Comm.*, 102 Ohio St. 3d 451, 452-53 (2004) ("With the advent of customer choice of a generator of electricity under S.B. 3, it became necessary for electric utilities to unbundle the three service components and their own components, so that customers could evaluate offers from competitive generators. Unbundling of the service components also ensured that an electric utility would not subsidize the competitive generation portion of its business by allocating generation expenses to the regulated distribution service provided by the utility. Conversely, it ensured that distribution service would not subsidize the generation portion of the business. In short, each service component was required to stand on its own.").

[114] R.C. § 4928.38.

[115] Even AEP Ohio recognizes that CRES providers merely act as "middlemen" for capacity provided to shopping customers. AEP Ohio Brief, p. 4 ("the CRES provider who currently wins a retail customer in AEP Ohio's service territory is merely a middle man . . ."); AEP Ohio Brief, p. 9.

operate efficiently.[116] AEP Ohio's argument misses the point. AEP Ohio has had market-based rates in place post-2000 that gave it the opportunity to recover the costs of environmental investment. Additionally, the Commission has approved additional cost-based recovery of AEP Ohio's environmental investments through adjustments to generation rates for SSO customers, approval of incremental capital carrying costs on 2001-2008 investment, and through the bypassable Environmental Investment Carrying Cost Rider ("EICCR").[117] Post-2000 investment is not removed from the embedded cost calculation because it wasn't made (or wasn't recovered), but because Ohio law prohibits its use in a cost-based calculation. To the extent this environmental investment has been recovered, shopping customers cannot be forced to pay for the same recovery again. And to the extent these investments have not yet been recovered, AEP Ohio remains free to recover them using market-based pricing, such as RPM pricing. In either case, post-2000 environmental investment should be removed from AEP Ohio's formula rate.

d. AEP Ohio has inappropriately included stranded costs in its analysis.

S.B. 3 also mandated that utilities were only permitted to recover for stranded costs during a statutorily designated transition period. Each electric utility was given an opportunity during a transition period to recover any previously-sunk costs in their generating facilities that would be uneconomic or "stranded" in competitive markets.[118] The PUCO was, and is, prohibited from authorizing "the receipt of transition revenues ***or any equivalent revenues*** by an

[116] AEP Ohio Brief, pp. 95, 106.

[117] Lesser Direct, p. 43-44 (citing Case No. 07-063-EL-UNC, and its holding that "the Companies may further adjust the generation rates and related riders of the standard service tariff . . . for increased expenditures. . . related to environmental requirements."). *See* Case Nos. 08-917-EL-SSO, *et al.*, Order on Remand, p. 13 (Oct. 3, 2011).

[118] R.C. § 4928.38-.40; Lesser Direct, pp. 10-11 (*citing* Case Nos. 99-1730-EL-ETP and 99-1731-EL-ETP, the "ETP Proceeding").

electric utility except as expressly authorized."[119] For AEP Ohio, that transition period has long since passed.[120] Despite the statutory prohibition on the recovery of stranded costs and AEP Ohio's own commitments in the ETP proceeding, AEP Ohio insists that it is entitled to recover stranded costs in this proceeding.[121]

AEP Ohio first claims that it should be permitted to recover stranded costs because the ETP cases were decided "based on an analysis of 2000-vintage information."[122] This is irrelevant because Ohio law does not permit AEP Ohio another bite at the stranded cost apple based on today's information. Indeed, Ohio law expressly provides the opposite. The PUCO is prohibited from authorizing the recovery of stranded costs after the transition period.[123]

AEP Ohio next claims that the ETP cases were retail cases, and have no bearing on wholesale charges to CRES providers.[124] As discussed above, this distinction is completely at odds with Ohio's statutory scheme. S.B. 3 was designed to create competition for generation services in Ohio, not to allow AEP Ohio to exercise monopoly power over its customers through above-market charges to CRES providers acting as "middlemen" in the provision of capacity to non-SSO retail customers.

AEP Ohio also presents an inaccurate and non-record description of the transition costs paid to the FirstEnergy utilities in 1999.[125] This paragraph of AEP Ohio's Brief should be stricken from the record or at minimum accorded no weight by the Commission as it is not

[119] *See* R.C. § 4928.38 (emphasis added).

[120] FES Brief, p. 36.

[121] AEP Ohio Brief, p. 103-13.

[122] AEP Ohio Brief, p. 103.

[123] *See* R.C. § 4928.38.

[124] AEP Ohio Brief, p. 105.

[125] AEP Ohio Brief, p. 107.

record evidence or relevant to any matter at issue in this case. The lone citation in this paragraph is to testimony which was later supplemented with revised (and lower) Generation Transition Charges ("GTC") and Regulatory Transition Charges ("RTC").[126] The un-cited reference to a "rate structure that paid [FirstEnergy] $7 billion"[127] is also incorrect, as the FirstEnergy utilities actually agreed in their ETP Stipulation to a transition through which the FirstEnergy utilities did not receive any additional incremental revenue. Rather, the FirstEnergy utilities' expenses increased due to amortization of the transition costs and their revenues decreased on an annual basis -- through a reduction in residential generation rates, which reduction included the GTC and RTC components, and a freeze in distribution rates through December 31, 2007.[128] The FirstEnergy utilities also made a substantial amount of generation available to CRES providers at below-market pricing,[129] a fact AEP Ohio ignores in its quest to "transition" to competition by charging CRES providers above-market pricing for capacity. A substantial portion of the stranded costs the Commission authorized the FirstEnergy utilities to "recover" through accelerated amortization were RTCs, which AEP Ohio also recovered.[130] Finally, this argument is irrelevant, because S.B. 3 authorized transition charges as part of the ETP cases. Simply because the FirstEnergy utilities and AEP Ohio received transition revenues in the past as

[126] *See* Case No. 99-1212-EL-ETP, Supplemental Testimony of FirstEnergy Corp. witness Harvey L. Wagner filed April 4, 2000. AEP Ohio's claim that the FirstEnergy utilities received $4.9 billion in above-market generation costs is also inaccurate. *See* Case Nos. 99-1212-EL-ETP, *et al*., Opinion and Order (July 19, 2000) (approving Stipulation with freeze of distribution rates, a freeze in generation rates with an additional 5% reduction in residential generation rates, FirstEnergy's agreement not to seek cost recovery during the market development period, and a reduction of up to $500 million in the RTC if certain shopping percentages were not met.)

[127] AEP Ohio Brief, p. 107.

[128] *See* Case Nos. 99-1212-EL-ETP *et al*., Opinion and Order, pp. 6-7 (July 19, 2000).

[129] *Id.*, p. 7.

[130] *Id.*, pp. 30-34; FES Ex. 106, p. 4 and Att. 1.

authorized by Ohio law does not mean that AEP Ohio can recover additional stranded costs today.

Finally, AEP Ohio claims that the Commission should consider a myriad of ways in which AEP Ohio claims it has been wronged since 1999 when deciding whether or not it should get a chance to recover stranded costs after the transition period has ended.[131] However, none of this is relevant to whether the pre-2001 stranded costs and post-2000 investment which AEP Ohio seeks to recover is authorized for recovery on a cost-basis, as opposed to a market-basis, under Ohio law. This would be similar to pointing to AEP Ohio's earnings history to argue that it should not receive market-based prices for capacity today, and is a red herring.

By its own admission AEP Ohio seeks "a three-year transition to market" in this case through the recovery of stranded costs in its formula rate.[132] Ohio law is clear. The Commission is not authorized to approve "transition revenues" for AEP Ohio after the transition period has ended.[133] Accordingly, any cost-based pricing system must remove these costs or violate the provisions of S.B. 3.

e. AEP Ohio's calculation is incorrect because it seeks to recover cost for assets it will no longer own after January 1, 2014.

AEP Ohio's capacity cost calculation improperly seeks to recover for costs which it will recover after January 1, 2014, the anticipated date of corporate separation. However, AEP Ohio will no longer own any generation assets after that date. It would be completely improper to approve a rate based on AEP Ohio's costs, when 18 months from now these assets will be owned by its competitive affiliate AEP Generation Resources. There is no justification and no legal basis for awarding AEP Ohio a cost-based rate based on assets it no longer owns.

[131] AEP Ohio Brief, pp. 107-112

[132] AEP Ohio Brief, p. 110.

[133] R.C. § 4928.38.

f. AEP Ohio failed to include an energy offset.

AEP Ohio's proposed formula rate double recovers for capacity costs by failing to include the contributions to embedded capacity costs from energy-related sales for resale.[134] In brief, AEP Ohio recovers a portion of its full embedded capacity costs through energy sales. When a customer shops, AEP Ohio is then free to sell the energy freed up by that shopping, and so a credit to the full embedded cost rate is necessary.

AEP Ohio opposes an energy credit on the theory that PJM has separated the markets for capacity and energy.[135] This is true, but each of these commodities are priced at market in the PJM construct. AEP Ohio attempts to deny customers the benefit of market pricing for capacity in this case, while reserving for itself the ability to make off-system energy sales at market prices. This flies in the face of the entire PJM market structure, and would lead to an improper double recovery for AEP Ohio. AEP Ohio's profits from energy-related sales recover embedded capacity costs and provide a return on embedded rate base.[136] Thus, AEP Ohio recovers a portion of its embedded costs twice: first, through energy sales and second through its embedded capacity cost.[137] Therefore an energy credit must be used to avoid an improper double recovery for these costs.

AEP Ohio seemingly admits that an energy credit is appropriate by arguing that if an energy credit is adopted that it be based on AEP Ohio's calculation.[138] However, AEP Ohio's energy credit is significantly flawed. AEP Ohio's energy credit includes a downward adjustment of 60 percent to reflect that a majority of energy revenues associated with AEP Ohio's

[134] Lesser Direct, p. 45; FES Brief, pp. 41-47.

[135] AEP Ohio Brief, pp. 4, 43.

[136] Lesser Direct, p. 45.

[137] Lesser Direct, p. 46.

[138] AEP Ohio Brief, p. 42.

generating facilities is shared with other members of the AEP East Pool.[139] This "sharing" adjustment is improper because AEP Ohio is proposing to recover its embedded capacity costs from shopping customers in Ohio, while also recovering some portion of those embedded costs from off-system energy sales. AEP Ohio should not be allowed to double recover these costs, particularly when it could have modified its Pool Agreement with other AEP entities at any point since 1999 to take Ohio shopping into account.[140] AEP Ohio should also not be allowed to attribute revenue to other AEP entities after January 1, 2014, as the Pool Agreement will no longer be in effect. Hence, any energy credit should be based on the full amount and not reduced for any amounts shared with other AEP East entities by virtue of a mechanism AEP created, manages, and can modify.

AEP Ohio next claims that off-system sale margins be reduced by 50% (with these funds being paid to AEP Ohio's shareholders) and then capped at 40% of the capacity charge.[141] These proposed modifications are completely unwarranted, as the goal of the energy credit is to capture the true net cost of AEP Ohio's capacity. As energy sales offset the gross cost of that capacity, there is no reason to limit the size of an energy credit or to pay a portion of those sales to AEP Ohio's shareholders.

2. If the Commission does not require AEP Ohio to charge market prices for capacity, then it should accept Dr. Lesser's cost-based approach.

Other than its attempt to recover stranded costs discussed above, AEP Ohio has largely ignored Dr. Lesser's testimony. As discussed above, removal of stranded costs from the capacity calculation does not mean that the associated capacity does not exist, but only that those costs must be recovered from the competitive market under Ohio law. After Dr. Lesser's appropriate

[139] Pearce Direct, pp. 17-18.

[140] Tr. Vol. I, p. 29.

[141] AEP Ohio Brief, p. 44.

adjustments to reflect the removal of: (1) stranded costs; (2) post-2001 investment; and (3) the minimum appropriate energy offset, AEP Ohio's true cost of capacity is $78.53/MW-day.[142] If adjusted to properly exclude the benefit of capacity equalization payments attributable to post-2000 assets, the estimated capacity cost is $90.83/MW-day.[143]

3. The annual development of a FERC formula rate and energy credit to set the state compensation mechanism will only invite confusion and litigation, as evidenced by the multiple arguments between AEP Ohio and Staff.

In contrast to the RPM-based market price for capacity, which is transparent and already known for all three planning years of AEP Ohio's proposed "transition" period, the complex calculations required to implement AEP Ohio's allegedly cost-based rate with an energy credit will result in continuing confusion and litigation. AEP Ohio pretends that this capacity rate can be developed in the few months between the publication of the FERC Form 1 for each year and the start of the planning year, but this simply ignores reality. If one takes AEP Ohio's fuel cases as an example, the audit process alone could take several years.[144] The parties would necessarily argue over the proper inclusion or exclusion of categories of costs, and the proper exclusion or inclusion of line items in various cost categories.[145] As shown by Staff's testimony, this would be true both with regard to the full embedded cost calculation and the energy credit calculation. Indeed, Dr. Pearce's energy credit calculation prepared for this proceeding itself included errors that he could not explain.[146]

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[142] FES Brief, p. 47.

[143] *See* FES Brief, pp. 47-48.

[144] *See* PUCO Case Nos. 09-872-EL-FAC, 09-873-EL-FAC, Opinion and Order, Jan. 23, 2012.

[145] Dr. Pearce admitted that preparation of the cost formula required him to identify and remove from the FERC-filed information certain costs such as those related to AEP Ohio's "lemonade stand" advertisements, dues and memberships, and political contributions. Tr. Vol. II, pp. 287-92.

[146] *See* Tr. Vol. II, pp. 270-71 (Dr. Pearce unable to explain why monthly energy rates on page 21 of Exhibit KDP-4 do not match monthly energy rates on Exhibit KDP-5, page 1 of 2).

Interestingly, AEP Ohio actually criticizes Staff witness Smith for making changes to the allegedly "FERC-approved formula rate" although Dr. Pearce makes his own "significant modifications" to the templates, both on the capacity side and the energy side.[147] AEP Ohio specifically identifies Mr. Smith's choice of ROEs as one such improper modification, although one of Dr. Pearce's "significant modifications" was to increase the template's ROE to 11.15% and to footnote that his altered ROE could not be changed "absent a Section 205/206 filing with the [Federal Energy Regulatory] Commission."[148] Mr. Smith appears to have the stronger argument regarding the appropriate ROE to use, which prompted AEP Ohio to, not surprisingly, selectively and deceptively quote from his testimony.[149] Regardless, this is but one example of a dispute that makes use of Dr. Pearce's template much more complex that claimed.

AEP Ohio also criticizes Mr. Smith's adjustments for generally resulting in decreases,[150] but this is easily explained by AEP Ohio's attempt to include nearly all costs in its chosen template. AEP Ohio accusing Mr. Smith of making a "conscious decision" to deliberately decrease Dr. Pearce's rate is ironic given that AEP Ohio made a conscious decision to select a template that has no application to a capacity-only rate. Likewise, AEP Ohio's argument that certain costs were "trapped"[151] in Staff's calculation ignores the question of whether any such costs should be included in the template in the first instance. AEP Ohio did

[147] AEP Brief, pp. 77-79; Pearce Direct, pp. 11-20.

[148] AEP Brief, pp. 79, 83-84; Pearce Direct, p. 11-12; Tr. Vol. II, pp. 256-58.

[149] AEP Brief, pp. 83-84. What AEP Ohio failed to quote was Staff witness Smith's actual opinion regarding the risk of the capacity charge: "for development of this type of rate, it's probably less risky because, I mean, whatever you're going to apply this rate to, I mean, it's going to be collected and earn the return that was used to develop the rate." Tr. Vol. IX, p. 1991.

[150] AEP Brief, p. 80.

[151] AEP Brief, pp. 81-82.

not present probative evidence that they should be, which presents yet another dispute that must be resolved in the future, presumably on an annual basis.

AEP Ohio also has challenged Staff witness Harter's treatment of the Amos and Mitchell units when calculating the energy credit,[152] which is a further example of the complexities resulting from AEP Ohio's participation in the AEP East Pool. AEP Ohio misrepresents Staff witness Harter's testimony as being "post termination of the AEP Pool" and being inconsistent with Mr. Smith's testimony.[153] To the contrary, Mr. Harter actually explained that his treatment of the Amos and Mitchell plants was entirely consistent with Mr. Smith's approach:

> [T]o be consistent with Ralph Smith's testimony, we removed the Mitchell plants from the -- from AEP Ohio's generation and margins. This is to avoid double counting the revenues through the AEP Interconnect Agreement."[154]

Because Mr. Smith included capacity equalization payments in the embedded cost estimate, Mr. Harter removed megawatts from the energy credit estimate that were equivalent to the megawatts that produced the capacity equalization payments. As AEP Ohio witness Nelson agreed (and has testified in the Modified ESP proceeding), "megawatts associated with AEP Ohio's share of Amos 3 and the Mitchell units are equivalent to the amount of megawatts sold in the last two years to other members of the AEP pool."[155] For the same reason that AEP Ohio is transferring these units in order to balance payments under the Pool, Staff witness Harter excluded these units from his energy credit model so as to ensure that payments under the Pool were not double-counted.

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[152] AEP Brief, pp. 47, 54; Nelson Supplemental, p. 15.

[153] Nelson Supplemental, p. 15.

[154] Tr. Vol. IX, p. 1783.

[155] Tr. Vol. XI, p. 2591.

The Pool Agreement, and its impending termination, also make it unwise to rely upon Dr. Pearce's template. Application of the Member Load Ratio or "MLR" to energy margins is always uncertain given that margins are administratively determined after-the-fact by the Pool.[156] Plus, although corporate separation and Pool termination are planned to occur by January 1, 2014, Dr. Pearce's template does not take either into account.[157] Once the Pool is terminated and corporate separation is complete, Dr. Pearce's proposal is that AEP Ohio's FERC Form 1 costs pre-corporate separation be used to determine the appropriate value for capacity sold by the Genco to AEP Ohio post-corporate separation.[158] Indeed, these costs will include the Amos and Mitchell plants that won't even be owned by the Genco.[159] Plus, Dr. Pearce's energy credit will apply the MLR to reduce the credit by 60% despite the fact that for the last seventeen months of the bridge period the Pool will have terminated and the MLR will not exist. AEP Ohio objects to Staff's application of the MLR, but the same arguments can be made against AEP Ohio's own proposed methodology. In either case, the complexity added to this supposedly simple "template" resulting from Pool termination and corporate separation argues strongly against the template's use.

A further complication arises from the need to properly account for all margins associated with energy sales if, as AEP Ohio proposes, a traditional cost-of-service calculation is used to estimate capacity costs. As occurs under the Prescott and Minden templates relied on by

[156] Mr. Meehan's estimates of gross margins did not take into account the fact that revenues from Pool off-system sales are accounted for after-the-fact. Tr. Vol. XII, p. 2691. AEP Ohio's repeated complaint regarding nodal vs. zonal modeling ignores that all energy margins from off-system sales under the Pool Agreement are allocated on a zonal basis, which would suggest that a nodal approach is irrelevant.

[157] Tr. Vol. II, p. 277.

[158] Tr. Vol. II, pp. 278-79.

[159] Tr. Vol. II, p. 278.

Dr. Pearce, capacity sales at cost must be accompanied by energy sales at cost.[160] AEP Ohio recovers a portion of its fixed costs through its generation-related charges to SSO customers, and AEP Ohio witness Nelson agreed that AEP Ohio should not double-recover these costs from CRES providers.[161] AEP Ohio's margin on its SSO sales is not reduced by its MLR under the Pool Agreement.[162] Thus, Staff included 100% of the margin from SSO sales and 40% of the margins from off-system sales in its energy credit. Given AEP Ohio's traditional cost-of-service approach to developing the state compensation mechanism, Staff's approach is not unreasonable.

However, as discussed elsewhere, there is no reason to apply a traditional cost-of-service approach here when it conflicts with the RPM design. The RPM auction results for the next three planning years give AEP Ohio, Ohio's consumers and CRES providers a transparent, known, easy-to-follow cost structure for capacity pricing. This pricing is directly tied to the RPM's sole function of valuing reliability. In contrast, the alternative pricing proposals proposed by AEP Ohio and Staff fail to advance the RPM's reliability objectives and fail to provide simple, known, transparent pricing. The Commission should reject these alternative proposals and adopt RPM-based pricing as the state compensation mechanism.

[160] Tr. Vol. II, p. 254.

[161] Tr. Vol. XII, pp. 2629-30.

[162] Tr. Vol. XII, p. 2630.

III. CONCLUSION

As set forth herein and in FES' initial Post-Hearing Brief, AEP Ohio's proposed $355/MW-day price for capacity provided to shopping customers should be rejected.

Respectfully submitted,

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I hereby certify that a copy of the foregoing *Post Hearing Reply Brief Of FirstEnergy Solutions Corp.* was served this 30th day of May, 2012, via e-mail upon the parties below.

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