BEFORE
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**

OHIO POWER COMPANY'S REPLY POST-HEARING BRIEF

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TABLE OF CONTENTS

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I. INTRODUCTION

In attempting to portray RPM-based capacity pricing as a requirement and cost-based capacity pricing as a pariah, parties in this case distort current law as well as regulatory history. A few parties openly admit the fact that Ohio Power Company's (dba AEP Ohio) customers have benefited for years from below-market rates and from Commission policies that were slow to embrace competition when market rates were high. Those same parties also distort the requirements of the current law relating to the future relationship between standard service offer (SSO) rates and market rates through a selective reliance on outdated provisions enacted as part of SB 3. While the passage of SB 221 was not a U-turn in regulatory policy, the reality is that the General Assembly did turn a sharp corner when it passed SB 221; most notably, the singular provision in RC 4928.14 requiring market-based SSO rates was repealed and was replaced by two very different options.

Under SB 221, the utility alone has the choice (not a requirement) to pursue the market rate option, under which there is a new and extended period of transition to get to fully market-based rates under the market rate offer (MRO) option. Unlike the prevailing assumption during passage of SB 3 that market rates would be lower than regulated rates, the General Assembly's new regime in passing SB 221 was premised upon market rates being higher than existing rates; thus, it established a new and extended transition period to very gradually subject customers to market rates over a period of 6-10 years. The General Assembly could not have envisioned the lower prices driven by shale gas or the major economic recession, both of which are significant events that developed after passage of SB 221. As for the electric security plan (ESP) alternative under SB 221, two primary features define this option: (1) there is much flexibility in developing a package of terms and conditions as long as the overall result is more favorable than the expected result of an MRO, and (2) the affected utility decides whether to consent to any modifications made by the Commission. There is no distinction in SB 221 between regulatory policies regarding retail versus wholesale competitive issues. Intervenor arguments in this case that largely rely on the SB 3 deregulatory construct, in claiming that AEP Ohio and the Commission are required to strictly and swiftly implement full competition through Reliability Pricing Model (RPM) pricing for capacity, are misguided and without support in the law.[1]

Competitive Retail Electric Service (CRES) providers had access to a mere \$46.73/MW-Day rate for capacity from June 2007 through May of 2008 – but where were they in the AEP Ohio service territory? Even those CRES providers that had their own generation resources to produce energy at competitive rates would likely have made an economically rational decision to seek the higher wholesale rates rather than compete for AEP Ohio retail load where they would have had to settle for less profit. Meanwhile, AEP Ohio was locked into its obligation to serve this load and forego billions of dollars in opportunity cost. CRES providers come and go as conditions boost their profit margin and they continually pursue a "best-of-all-worlds" business model; Meanwhile, AEP Ohio remains the default SSO provider and is locked in to providing a

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[1] As a related matter, AEP Ohio submits that the General Assembly never envisioned the Commission's current preference for approving an MRO-style SSO "within an ESP" like it has done for FirstEnergy and Duke Energy Ohio – in much the same manner that the creators of SB 3 never envisioned RSPs after the market development period. The ESP and MRO are binary choices (indeed, the MRO is a permanent one-way path that cannot be revoked) and the legislative design does not mix the two options together. Even assuming the "MRO within an ESP" format is permissible, however, it is not a construct that can be forced upon AEP Ohio. While AEP Ohio's pending Modified ESP proposal transitions to a fully competitive SSO structure in *half* the *minimum* period allowed under an MRO option, the Commission must not upset the balanced approach set forth in the Modified ESP by forcing an unlawful and unreasonable result in this case.

pre-established SSO rate years in advance to all customers, whether they have shopped and returned many times or have never shopped.

As it has responded in the past, AEP Ohio has cooperatively embraced the Commission's new policy that desires an expeditious move toward a fully competitive SSO environment. AEP Ohio's Modified ESP filing, currently pending before the Commission, reflects a swift movement to a fully competitive SSO structure – in *half* the *minimum* time period permitted under an MRO. This brief period is needed in order to complete full corporate separation; to work through dissolution of AEP's 60-year old generation pool with the supervision and approval of Federal Energy Regulatory Commission (FERC); and to wind-up AEP Ohio's Fixed Resource Requirement (FRR) obligations that cannot terminate until mid-2015. Fairly providing AEP Ohio a cost-based capacity charge during the 2012-2015 period is an integral part of this plan and signals an aggressive move toward – not away from – full retail competition in Ohio. This approach, in tandem with the Company's Modified ESP proposal, will benefit all parties through the elimination of confusion and uncertainty associated with continued litigation before FERC and elsewhere related to AEP Ohio's wholesale capacity charge.

II. AEP OHIO IS ENTITLED TO CHARGE A COST-BASED PRICE FOR THE CAPACITY IT SUPPLIES TO CRES PROVIDERS.

A. While FERC Proceedings Remain Pending to Determine AEP Ohio's Right Under Section D.8 Of Schedule 8.1 Of The RAA To Establish A Rate For Capacity That Is Cost-Based, No Party Challenges This Commission's Option Under The RAA To Establish A Cost-Based Capacity Charge As Its State Compensation Mechanism.

The PJM Interconnection, L.L.C. (PJM) Reliability Assurance Agreement (RAA) entitles AEP Ohio to charge a cost-based rate to CRES providers for the capacity it supplies to them. AEP Ohio actively participated in drafting Section D.8 of Schedule 8.1 and, at the time Section D.8 was drafted, AEP Ohio understood that provision to provide AEP Ohio with the right to elect to charge a cost-based price to CRES providers for the capacity that it supplies to them. (*See* AEP Ohio Br. at 13-15.) Moreover, AEP Ohio fully expected that, should Ohio one day adopt a state compensation mechanism that would implement a retail capacity charge directly to retail customers, that provision would still allow AEP Ohio to recover its costs for the capacity that it is obligated to supply. (*Id.* at 14-15; AEP Ohio Ex. 103 at 10.) Regardless of the outcome of the dispute pending before FERC as to AEP Ohio's right under the RAA to establish a cost-based rate (that is a matter for FERC to decide), it is clear that this Commission's State Compensation Mechanism under the RAA may be cost-based.

Consistent with the Company's understanding, Section D.8 explicitly states that an FRR entity may change the basis for compensation to a cost-based method at any time. (AEP Ohio Br. at 13-14.) Despite this clear directive, FES, OCC, RESA/DE, Exelon, and DER/DECAM contend that Section D.8's unambiguous language only allows an FRR Entity to collect a cost-based charge from CRES providers if there is no state compensation mechanism in place. (*See* FES Br. at 9-10; OCC Br. at 6-7; RESA/DE Br. at 11-12; Exelon Br. at 6; DER/DECAM Br. at 6-7.)[2] These arguments not only ignore the evidence presented by AEP Ohio witness Horton regarding the Company's understanding of the RAA at the time it was drafted, they also ignore

[2] IEU posits that AEP Ohio violated the Ohio Rules of Civil Procedure, specifically Rule 10(D), by failing to "submit the RAA to support its claim or explain its failure to do so." (IEU Br. at 2, n.2.) But the Rule quoted by IEU requires instruments to be attached "*to the pleading*." Civ. R. 10(D) (emphasis added). Rule 7, in turn (not quoted by IEU), defines a "pleading" as either (1) a complaint; (2) an answer; (3) a reply to a counterclaim; (4) an answer to a cross-claim; (5) a third-party complaint; or (6) a third-party answer. "*No other pleading shall be allowed*." Civ. R. 7(A) (emphasis added). IEU fails to identify any such "pleading" to which AEP Ohio was required to attach the RAA, because there has been no such "pleading" submitted in this proceeding. IEU's misguided invocation of the Civil Rules pertaining to the "form of pleadings" is a red herring. Given that IEU complains about the "resource burn" that it has been required to endure in this case (IEU Br. at 14) and that it seeks a "cash payment" of its litigation costs (*id.* at 70), IEU's willingness to waste the parties' (and the Commission's) time and resources on bogus invocations of inapplicable procedural rules is telling.

the fact that Section D.8 and its meaning are presently under FERC review. (*See* AEP Ohio Br. at 15, n.10.) While the meaning of the RAA is a FERC matter to decide, this Commission can decide that its State Compensation Mechanism should be cost-based – and that is the only fair and reasonable option to avoid undue financial harm to AEP Ohio while it remains an FRR entity.

Moreover, it is plain that the word "cost", as used in Section D.8, refers to embedded costs. As AEP Ohio witness Horton testified, AEP Ohio expected that, as drafted, Section D.8 would allow AEP Ohio to recover its embedded costs. (*Id*. at 14; AEP Ohio Ex. 103 at 9-10.) Nonetheless, OCC, FES, and RESA/DE argue that the RAA does not address embedded costs and that the term "cost" in Section D.8 means avoided costs and that FES witness Stoddard's opinion that the term "cost" means avoided cost should control its definition. (*See* OCC Br. at 7; FES Br. at 29-32; RESA/DE Br. at 13-14.) These arguments, however, are unavailing; as AEP Ohio witness Horton pointed out at the hearing, "avoided cost" also does not appear in Section D.8. (Tr. II at 532-533.) Since avoided costs are bid into the Base Residual Auction (BRA), FES and OCC wrongly conflate "costs" with RPM, rendering the option to establish a cost-based rate meaningless. Further, in a regulatory context, including before the FERC, the use of the unqualified term "cost" can only be logically interpreted to mean full embedded cost. If Section D.8 meant "avoided" cost then it would need to be explicitly stated to provide that meaning to any informed reader of the document. It is also telling that witness Stoddard admitted that avoided cost has been below the RPM rate (*see* Tr. VIII at 1622-1624), which suggests the effort to establish a cost based alternative to RPM was rather pointless. In the final analysis, it simply makes no sense whatever to conclude that avoided costs are a backstop remedy for the marginal pricing regime of the RPM. Again, the interpretation of the RAA is ultimately a matter for, and is the subject of multiple proceedings pending before. the FERC.

RESA/DE contend that allowing AEP Ohio to recover its embedded costs will "halt development of competition" and conflict with the stated purpose of the RAA. (RESA/DE Br. at 14.) This, however, is simply not the case. As Company witness Allen testified, CRES providers will be able to compete profitably at the Company's proposed $355.72/MW-Day embedded-cost capacity rate and, in fact, shopping presently is occurring at capacity prices that are well above RPM. (*See* AEP Ohio Br. at 16-17; Tr. XI at 2330-2333.)

Notably, the State of Michigan is presently establishing a State Compensation Mechanism based on embedded cost.[3] The Michigan Public Service Commission recently directed I&M to file a proposal whereby the capacity charge for shopping customers will be comparable to the capacity charge embedded in non-shopping customer rates. *See* Michigan PSC Case No. U-17032, 2012 WL 1902469, Order (May 24, 2012).at 2-3. Thus, Michigan intends to establish a cost-based rate for I&M to be compensated for providing capacity to support shopping load as part of its FRR obligation. Obviously, Michigan's course supports

[3] IEU and FES maintain that the Indiana Michigan Power (I&M) case's (FERC Docket No. ER12-1173-000) procedural suspension because the application "may be unjust or unreasonable" favors their view that RPM pricing is the best policy. (IEU Br. at 6-7; FES Br. at 8-9.) The FERC's application suspension, however, does not portend the ultimate disposition of the case. The Ohio Commission also has a procedure for suspending cases and often makes a finding that a proposal "may be unjust or unreasonable" in order to establish a procedural schedule – only to subsequently approve the application. (*See e.g*., Case No. 09-759-EL-ESS, Entry (July 30, 2010) (setting procedural schedule and hearing because application "may be unjust or unreasonable"), Opinion and Order (Dec. 15, 2010) (approving stipulation); Case No. 05-792-EL-ATA, Entry (Oct. 4, 2005) (setting procedural schedule and hearing because application "may be unjust or unreasonable"), Opinion and Order (Mar 1, 2006) (approving application subject to modifications).) Further, the FERC accepted the filing to be effective October 1, 2012, subject to the outcome of a merit decision. More importantly, this argument also fails to acknowledge that the Michigan Commission issued an order recently making clear its intention to establish a cost-based State Compensation Mechanism. *See* Michigan PSC Case No. U-17032, 2012 WL 1902469, Order (May 24, 2012).

AEP Ohio's position, not IEU's or FES's position. Michigan has retail choice and has determined that establishing a cost-based State Compensation Mechanism is reasonable for an FRR entity..

Accordingly, for the reasons set forth above and those contained in the Company's Initial Brief, the Commission should agree that the RAA specifically requires that AEP Ohio be permitted to recover its embedded costs of capacity and should allow AEP Ohio to implement its proposed capacity charge. At a minimum, it must be acknowledged that AEP Ohio's right to establish a cost-based rate under the FRR option is the subject of pending FERC proceedings in AEP Ohio's Section 205 and Section 206 actions (FERC Docket Nos. ER11-2183-000 and . EL11-32-000). In any event, no party challenges the notion that it is permissible for a State Compensation Mechanism to be based on cost – some parties merely dispute the wisdom of doing so.

B. AEP Ohio's Proposed Cost-Based Capacity Rate Advances Commission And State Policy Objectives.

The Company's proposed cost-based \$355.72/MW-Day capacity rate satisfies both of the objectives that the Commission articulated in March 2012. (*See* AEP Ohio Br. at 16-23.) First, as the Company has demonstrated, the proposed capacity rate promotes alternative supply and retail competition. (*Id.* at 16-19.) Indeed, as discussed above and in AEP Ohio's Initial Brief, Company witness Allen demonstrated that there will be an opportunity for customers in all classes to shop, and for CRES providers to earn margins, at the Company's proposed \$355.72/MW-Day full-cost capacity rate. (*Id.*; Tr. XI at 2330- 2331.) RPM-based pricing, by contrast, would induce an uneconomic bypass or subsidy for CRES providers at the expense of AEP Ohio's customers and shareholders and would not foster efficient or durable competition. (*Id.* at 18.) The General Assembly did not mandate competition for competition's sake. Rather, the State policy is to promote "effective competition," R.C. 4928.02(H), by avoiding subsidies in favor of competitive services. Contrary to the assertion by Dominion Retail (at 6) that CRES providers would be subsidizing non-shopping customers if a cost-based capacity charge is adopted, there would be no dispute about cross subsidies if both shopping and non-shopping customers pay a comparable rate for capacity. As AEP Ohio witness Allen demonstrated in his rebuttal testimony, non-shopping customers pay a capacity charge roughly equivalent to the Company's proposed capacity charge for CRES providers to support shopping load. (*See* AEP Ohio Ex. 142 at 19-20.)

Second, as the Company has demonstrated, the proposed capacity rate also satisfies the Commission's second objective, which is to ensure that AEP Ohio is able to continue to attract capital. (AEP Ohio Br. at 19-23.) This ability to continue to attract capital in turn comports with the state policy articulated in R.C. 4928.02(A), which is to "[e]nsure the availability to consumers of adequate, reliable, safe, efficient, nondiscriminatory, and reasonably priced retail electric service." (*Id.*) RPM-based rates, however, would undermine AEP Ohio's ability to provide customers with adequate and reliable service because the yearly price fluctuations attendant to the RPM auction (which in past years have been dramatic) make investment in Ohio generation assets undesirable and could lead to long-term in-state capacity deficiencies. (*Id.* at 22-23.)

Intervenors advance a number of policy arguments against AEP Ohio's proposal. Many of these arguments have already been addressed above and in AEP Ohio's Initial Brief. And they repeat the same refrain – that AEP Ohio's proposed capacity charge purportedly would impair shopping or would be anticompetitive and, therefore, violate Ohio law. (Schools Br. at 8; Exelon Br. at 8, 10; FES Br. at 10-12, 52-62; OCC Br. at 12-14; IGS Br. at 9-11, 13-14; IEU Br.

at 56-59; NFIB Br. at 2-3; Dominion Br. at 7-8; OMA/OHA Br. at 17-21; RESA/DE Br. at 17-18.) These concerns are misplaced, given that AEP Ohio has demonstrated that shopping will continue to occur at $355.72/MW-Day. (*See* AEP Ohio Br. at 17-18.) That the amount of shopping may not increase as significantly as if AEP Ohio were required to provide capacity at the near-zero RPM rates does not mean that a rate higher than RPM does not promote competition. Indeed, contrary to Schools witness Frye's testimony that AEP Ohio's financial well-being should be disregarded in favor of increased diversity of electric suppliers (Tr. IX at 1764), the Commission's focus in this proceeding should not be on harming AEP Ohio for the sake of uneconomic, unsustainable shopping, but on fair and balanced competition. AEP Ohio's proposal would allow for fair and balanced competition and, therefore, should be approved.

A number of Intervenors also opine that AEP Ohio's proposed capacity charge would lead to retail consumers paying a rate for capacity that is not "reasonably priced," in violation R.C. 4928.02(A). (*See* Schools Br. at 7-8; FES Br. at 11-12; OMA/OHA Br. at 17-21; RESA/DE Br. at 18-19.) They have failed, however, to offer any evidence in support of this assertion. AEP Ohio, by comparison, has demonstrated that the contracts between CRES providers and retail customers accommodate an increase in the capacity charge such that retail customers would not be forced to pay an unreasonable price for electric service. (*See* AEP Ohio Br. at 18-19.) Indeed, a CRES provider has the option to absorb an increase in its price of capacity, and retail customers also have the right to terminate their contract with a CRES provider if their prices become too high. (*Id.*) In any case, a rate that is based on cost is inherently reasonable. There would no requirement, therefore, that retail customers pay an unreasonable price for electric service. Moreover, in addition to reasonable price, it is important to keep R.C. 4928.02(A)'s other critical considerations – adequate, reliable, safe, efficient, and nondiscriminatory retail electric service – in mind when assessing whether AEP Ohio's proposal satisfies the state policy set forth therein.

Some parties even contend that the Commission has already decided against a cost-based capacity charge in favor of RPM. For example, OCC argues that the Commission already adopted RPM pricing and that there is apparently nothing more to decide in this docket. (*See* OCC Br. at 6.) Similarly, Exelon claims that the Commission "has already rejected cost-based pricing as the proper choice for AEP Ohio," as reflected in its December 8, 2010 Entry. (Exelon Br. at 6.) Of course, the Commission has only recently indicated that it has not pre-judged the outcome of this case. *See* Case No. 10-2929-EL-UNC, Entry at 15-17 (Mar. 7, 2012). More to the point, the Commission has invested significant resources into this complex proceeding through the process for discovery, testimony, hearing and briefing. These parties wrongly attempt to make a mockery of this complex adjudicative proceeding by suggesting the outcome is already pre-determined.

In a similar vein, Staff and others recite the factual background of this case as if the Commission's eventual reversal of its decision to adopt the Stipulation in Case Nos. 11-346-EL-SSO, *et al*. somehow implied a specific rejection of the two-tiered capacity charge that was part of the Stipulation. (*See, e.g.,* Staff Br. at 8.) The reality is that the rejection of the Stipulation contained no indication that the Commission had any concerns or regrets about its decision to adopt the two-tiered capacity charge. Indeed, in its December 14, 2011 Opinion and Order initially approving the ESP 2 Stipulation, the Commission specifically found that the two-tiered capacity charge is reasonable. Case No. 10-2929-EL-UNC, Opinion and Order at 54 (Dec. 14, 2011). When it subsequently rejected the Stipulation, the Commission did so on only two grounds – neither of which related to its previous approval of the two-tiered capacity charge. *See* Case No. 10-2929-EL-UNC, Entry on Rehearing at 11-12 (Feb. 23, 2012).

On the contrary, the Commission continued its reliance on the two-tiered capacity charge even after rejection of the Stipulation. As the Commission noted in its March 7, 2012 Entry granting AEP Ohio's request that the two-tiered capacity charge remain in place as interim relief through May 31, 2012, and as it again noted in its May 30, 2012 Enty granting AEP Ohio's request that the Commission extent the interim relief until the Commission issues its final decision in this proceeding, the Commission rightly relied upon record evidence presented in the ESP 2 Stipulation hearing in its decision and found support in the record that, as applied to AEP Ohio for the interim period, the state compensation mechanism could risk an unjust and unreasonable result. *See* Case No. 10-2929-EL-UNC, Entry at 15-16 (Mar. 7, 2012), Entry (May 30, 2012). Moreover, the Commission explicitly explained that it is "vested with the authority to modify the state compensation mechanism established in [the] December 8, 2010, entry in this case." *Id.* at 15. After the Commission implemented a non-RPM capacity pricing mechanism during such a critical period of this dispute for AEP Ohio, Intervenors cannot accurately claim that the Commission's policies automatically prevent continuation of a non-RPM solution.

Staff argues that AEP Ohio's proposed capacity charge is "unjust or excessive" and that Staff's alternative cost calculation "balances the interests of AEP Ohio and promoting competition." (*See* Staff Br. at 2.) It is not clear how the calculation of a cost-based rate involves balancing of interests – it should simply be an allocation of costs and offsetting revenues based on an audit. Ironically, Staff refers (perhaps inadvertently) to its proposal (at 2) as Staff's "alternative RPM rate" even though it purports to be a cost-based rate calculation; the irony stems from the highly unusual coincidence that Staff's alternative cost-based rate was virtually equal to the current RPM price (*i.e.*, $146/MW-Day). Indeed, elsewhere on brief, Staff acknowledges that the current RPM rate "is equivalent to Staff's alternative proposed rate." (*Id.* at 4.) When asked about this equivalence during cross examination, however, neither Staff witness Harter nor Medine acknowledged or explained this extraordinary coincidence.[4] (Tr. IX at 1844-1845; Tr. X at 2161-2163.) In any case, if the Commission is to establish a cost-based rate, it should not reduce the rate simply to boost shopping statistics – especially given the financial harm to AEP Ohio associated with RPM pricing. After all, the policy in R.C. 4928.02(H) is to encourage "effective competition" and not uneconomic shopping. Accordingly, for these reasons and those set forth in the Company's Initial Brief, state policy weighs in favor of the Commission approving AEP Ohio's proposed capacity charge.

C. During The Period In Which AEP Ohio Remains An FRR Entity, RPM Is Not An Appropriate Basis Upon Which To Price AEP Ohio's Capacity.

In their briefs, Intervenors make many now-familiar arguments in opposition to a cost-based rate. A number of parties argue that RPM will not cause AEP Ohio financial harm. (*See* NFIB Br. at 3-5; FES Br. at 22-27; RESA/DE Br. at 15-17; OMA/OHA Br. at 13-17.) A number of parties argue about which approach – RPM pricing or cost-based pricing – creates unwanted subsidies. (*See* IEU Br. at 56-59; Dominion Br. at 6-7; IGS Br. at 7-8, 12-13; FES Br. 20-22.) Others reiterate the complaint that, in their view, AEP Ohio's decision to pursue its contractual

[4] AEP further notes that as Mr. Harter apparently attempted to begin correcting his errors, his energy credit began to decrease from $154.24/MW-day to $127.38/MW-day based on his second iteration. Subsequently, Staff's final value was modified yet again back to the $152.41/MW-day as supported by Staff witness Medine. This again is an amazing coincidence that the original energy credit resulted in a Staff capacity rate of $144.58/MW-day, very nearly the current RPM rate of $145.79/MW-day. However, after another version was provided that lowered the energy credit, and thus increased the capacity charge to approximately $171/MW-day, a final "corrected" version was offered by Staff that once again lowered the capacity rate yet again to $152.41/MW-day -- an almost identical number to the original value provided despite supposedly correcting for many errors and one that yet again resulted in an alternative rate very nearly the same as the current RPM rate.

right to cost-based compensation for the capacity it supplies to CRES providers is the Company seeking the "higher of cost or market" price. (Exelon Br. at 9; Dominion Br. at 3-4; OCC Br. at 11; FES Br. at 7.) Other Intervenors espouse their belief that RPM-based pricing should be adopted because the RPM auction is a "true" and economically efficient market. (*See* Kroger Br. at 2-4; FES Br. at 12-20; RESA/DE Br. at 22-26; IGS Br. at 14-15; Exelon Br. at 11.) And others remark that because Ohio law does not require the Commission to implement cost-based capacity pricing, the Commission should choose RPM. (Dominion Br. at 5-6; Exelon Br. at 5-6.)

In its Initial Brief, the Company proactively addressed at length the reasons why RPM is not an appropriate basis upon which to price AEP Ohio's Capacity while it is an FRR Entity. Specifically, the Company explained that due its unique position as an FRR Entity through May 31, 2015, and attendant obligation to provide long-term capacity for all of the load in its distribution franchise territory (including the load that is served by CRES providers), RPM-based capacity pricing is not compensatory. (*See* AEP Ohio Br. at 23-26.) AEP Ohio also demonstrated that its pooling agreement – which will remain in effect until January 2014 – requires pool members that are short on capacity to purchase it from those members that have excess capacity (like AEP Ohio) at embedded cost pricing. (*Id.* at 26-27.) Allowing a CRES provider to purchase capacity for less than AEP Ohio's embedded costs would be to allow the CRES provider an unfair and discriminatory preference over the other members of AEP Ohio's pooling agreement and their customers. (*Id.*) Third, AEP Ohio demonstrated that RPM pricing will cause financial harm to AEP Ohio during the period through May 31, 2015, because RPM pricing is not compensatory. (*Id.* at 27-28.) The Company also demonstrated that RPM pricing would award CRES providers an unfair and illegal subsidy at the expense of AEP Ohio's SSO customers and shareholders, in violation of R.C. 4928.02(H). (*Id.* at 29-31.)

The Company also demonstrated why a number of Intervenors' arguments are misplaced, including arguments: (1) that Ohio law does not require that a state compensation mechanism be cost-based; (2) that RPM pricing is consistent with Ohio state policy directives set forth in R.C. 4928.02; (3) that AEP Ohio should not be permitted to choose cost-based pricing now, when market prices are low, because it has previously made capacity available to CRES providers at RPM; (4) that PJM's rules have created a situation in which CRES providers are "captive" to AEP Ohio because CRES providers would have had to purchase and commit capacity to serve retail customers more than three years in advance of delivery, at a time when they had few or no committed retail customers; (5) that AEP Ohio's proposed capacity pricing, if adopted, would be discriminatory because other capacity is sold at RPM in other service territories in the state; and (6) that RPM should be adopted because the RPM auctions are a competitive market for capacity and reflect "true, transparent market and competitive conditions." (*Id.* at 31-34.)

FES also attempts to rely on AEP Ohio's own witnesses and suggests (at 12-14) that AEP Ohio should have listened to its outside expert witnesses. In particular, FES points out (at 12) that Mr. Meehan has consistently advocated pro-competition policies and offers (at 13) that Mr. Graves is also a pro-market advocate. What FES conveniently forgets is that both of those pro-competition witnesses support AEP Ohio's position in this case. Of course, FES does not accept those positions and does everything it can to discredit the ultimate conclusions of Graves and Meehan, because it cannot understand why an advocate of competition does not agree with all of FES's positions. AEP Ohio also supports competition and is trying to restructure its business model and un-wind its existing obligations in order to get to a fully competitive SSO in half the minimum period it takes to implement an MRO. FES's attempt to selectively commandeer AEP Ohio's witnesses should be ignored.

In a similar vein, Dominion Retail attempts to use AEP Ohio's offer of compromise as part of a package in the Modified ESP case against the Company in this proceeding. Specifically, Dominion Retail alleges that AEP Ohio's offer in the Modified ESP to provide two-tiered discounted capacity for $146/$255 per MW-Day really shows that AEP Ohio "is willing to provide capacity at something below its version of a cost-based rate" and that "it clearly indicates a rate of return below that used by AEP Ohio in its cost analysis will not result in a confiscatory capacity charge..." (Dominion Br. at 8.) This argument is completely inaccurate and misinformed. Dominion Retail's perspective also prejudges, and squarely conflicts with, the record still being created in the Modified ESP case concerning the two-tiered capacity charge alternative being presented therein. There can be absolutely no ambiguity on this point for someone who reads AEP Ohio's pre-filed testimony and has heard the live testimony given by AEP Ohio witnesses: the two-tiered capacity charge is being offered only as a component of a package of terms and conditions, including the Retail Stability Rider, and is not being offered or accepted independent of that package.

FES's assertion (at 27-28) that AEP Ohio has not dedicated its own resources to serve Ohio customers, and therefore its formula tied to the cost of these units cannot be utilized, is simply wrong. IEU (at 50-55) also makes a similar claim. Although the FRR plan historically has been jointly submitted on behalf of the AEP East operating companies, it is an obvious feature of the FRR (accepted in all of the AEP East jurisdictions) that the resources supplied start with the generation assets owned by the operating company supplying the load. (AEP Ohio Ex. 103 at 4-5; AEP Ohio Ex. 102 at 5.) Only shortfalls are supplied from other resources or surpluses sold to other parties with offsetting revenue credits. As confirmed by the record in this case, AEP Ohio owns and operates generation assets that are included in the FRR plan in order to serve Ohio retail load. The capacity cost associated with those plants, adjusted to reflect operation of the FERC-approved Pool impacts, is the cost of capacity to serve the Ohio retail load (including shopping load). And non-shopping SSO customers already pay a rate that approximates the $355/MW-Day rate proposed in this case for shopping customers. (*See* AEP Ohio Ex. 142 at 19-20.) Consequently, AEP Ohio's proposal is fully consistent in terms of a formula based on the costs of assets and resources used to serve the AEP Ohio load. RPM, on the other hand, has no such relationship with the assets and resources used to serve AEP Ohio's load given that AEP Ohio did not participate in the RPM. Thus, if dedication were considered to be a dispositive factor in determining the appropriate rate, the RPM construct would fail that test.

FES further argues that "[i]f AEP Ohio were free to sell this capacity, the best approximation of what it would receive is the RPM price." (FES Br. at 19.) This is simply not true. All parties that sell or buy capacity into RPM have an ability to make bilateral agreements to support or discharge their capacity obligations, thus muting or nullifying any impact on the RPM price. Such agreements on any basis can be – and frequently are – for terms different than a single RPM year so the price would most assuredly be different, including embedded cost rates. In any case, the notion that AEP Ohio is free to sell its capacity somewhere else is purely hypothetical at this point, because AEP Ohio became a "captive seller" of capacity for all connected load in its service territory, due to the CRES providers' choice not to provide their own capacity to serve their own shopping load. As a related matter, FES discusses regulatory pass-through provisions and out clauses. (*Id.* at 52-55.) FES makes it perfectly clear that it will either make a profit or drop customers back to the SSO – it is not willing to accept the risk of not making profit. FES witness Banks provided a striking example of this when he stated in his oral supplemental direct testimony that FES returned all of its customers in the FE service territory back to SSO service when there was uncertainty related to the FE EDU's ESP plan only a few short years ago in 2009. (Tr. VIII at 1654-55.) By contrast, FES advocates that AEP Ohio participate under rules wherein it must stay in the market as a captive seller to supply capacity to CRES Providers while losing money.

Finally in this regard, FES mischaracterizes AEP's FRR election by suggesting that it was done to "avoid the risk of units not clearing the BRA." (*Id.* at 5.) While failing to clear units in the BRA is something that FES has directly experienced in connection with the 2015-2016 BRA (even with an auction clearing price of $357/MW-Day), the fear of units not clearing the BRA has nothing to do with why AEP Ohio elected the FRR option. In reality, AEP Ohio's FRR election saved its retail customers in Ohio millions of dollars. Other parties have been more intellectually honest on brief about the historical context of the FRR option and the long and winding path toward market rates in Ohio. For example, Dominion Retail says that it "understands the predicament in which AEP Ohio now finds itself is not of its own making, and that, had it been permitted to proceed with its earlier plans to divest itself of its generation, this issue would not have arisen." (Dominion Br. at 6-7.) OEG also provides an accurate historical account of the regulatory history involving the implementation of SB 3.

> Since S.B. 3 was enacted in 1999 and Ohio began its long march to market-based generation supply, Ohio Power Company ("AEP Ohio") has consistently been a below-market supplier. While states like Maryland and Illinois suffered through calamitous rate hikes and near ratepayer rebellion caused by an undeveloped and dysfunctional wholesale power market, Ohio consumers benefited from below-market prices made possible by Rate Stabilization Plans ("RSPs") initiated by the Public Utilities Commission of Ohio ("PUCO" or "Commission") during 2006-2008 (for which there was scant legislative authority). The below-market rates generally continued during AEP Ohio's first Electric Security Plan ("ESP") under S.B. 221. Maintaining below-market rates when AEP Ohio arguably had a legal basis to do otherwise was no doubt beneficial to the Ohio economy.

(OEG Br. at 102 (note omitted).) While OEG goes on to discuss other matters and ultimately to disagree with AEP Ohio's position in this case, the above-quoted account of the SB 3 implementation is accurate and AEP Ohio appreciates OEG's frank appraisal of that important point.

The Commission actively encouraged AEP Ohio to undertake the FRR obligation at a time when doing so matched up with the interests of ratepayers and Ohio's economy. Under the FRR (unlike the RPM), AEP Ohio cannot opportunistically move in and out of providing capacity needs of its customers when it is economically favorable to do so. The FRR obligation involves bypassing RPM auction prices (and RPM market opportunities) and will continue for AEP Ohio through mid-2015. Consequently, AEP Ohio should not be subjected to RPM pricing during that period. For the reasons discussed above and on pages 23-34 of its Initial Brief, AEP Ohio requests that the Commission recognize that RPM-based pricing is not an appropriate state compensation mechanism for the period while AEP Ohio remains an FRR Entity.

III. THE APPROPRIATE COST-BASED CAPACITY PRICE TO BE CHARGED TO CRES PROVIDERS FOR CAPACITY SUPPORTING SHOPPING LOAD IS $355.72/MW-DAY.

A. The Appropriate Cost-Based Capacity Charge is $355.72/MW-Day And Is Based Upon AEP Ohio's Costs Before Consideration Of Any Offsetting Energy Credit.

As AEP Ohio demonstrated at pages 36-42 of its Initial Brief, Dr. Pearce's formula rate approach is a fair, FERC-approved approach to calculating an appropriate cost-based capacity price of $355.72/MW-Day. His approach is currently used in many states for other wholesale sales, and underwent heavy regulatory review from FERC staff in the Minden/Prescott wholesale capacity transactions. (AEP Ohio Ex. 102 at 8; Tr. II at 251.) Dr. Pearce's approach has added advantages of transparency and currency, in that the inputs for his template are derived directly from the FERC Form 1 annual reports of the Company, readily available for verification, and would be updated using the most current accounting information. Dr. Pearce also noted at hearing that the result of his methodology has been "incredibly stable" based on the latest FERC Form 1 data from 2011. (Tr. II at 12.) And Mr. Allen responded to Commissioner Porter's inquiry at hearing regarding the projected earnings of AEP Ohio if the Company collected a capacity charge rate of $355.72/MW-Day from CRES providers, estimating in his rebuttal testimony that the Company's return on equity "would be a reasonable 12.2% in 2013." (AEP Ex. 142 at 21.) As such, the appropriate cost-based capacity charge is $355.72/MW-Day, before consideration of any offsetting energy credit.

B. If An Energy Credit Is Used To Partially Offset The Demand Charge, It Should Reflect Actual 2010 Energy Margins Or At Least A Realistic And Accurate Projection Of Anticipated Energy Margins To Be Realized During The 2012-2015 Period.

The result of both EVA's initial (Harter) and subsequent (Medine) efforts is an energy credit calculation that suffers from a number of fundamental flaws. Each of EVA's fundamental errors consistently produces significant overstatements of the energy margins that AEP Ohio is projected to realize. Staff admits that its approach is a mismatch in that "EVA did a market-based analysis and Mr. Smith did a cost-based analysis." (Staff Br. at 47.) Further, Ms. Medine described the work she did to forecast the energy credit and the work Staff witness Smith did to calculate the demand charge based on actual cost as "two different things." (Tr. X at 2173.) Ms. Medine also acknowledged that even though her forecasted energy credit was used as an offset to Mr. Smith's demand charge, the two components were different analyses that do not use the same method. (*Id.* at 2171.) Moreover, Mr. Smith's analysis uses 2010 data while Ms. Medine's calculation relates to the 2012-2015 time period. Finally in this regard, Ms. Medine characterized AEP Ohio witness Pearce's calculation of an energy credit based on actual 2010 data as "apples to oranges" compared with her forecast (*Id.* at 2172). In sum, EVA's demand charge and energy credit are structurally inconsistent, primarily due to an inappropriate development of the energy credit through a flawed projection.

As detailed in AEP Ohio's testimony and Initial Brief, EVA committed a host of errors in developing its overstated energy credit:

- EVA's methodology does not withstand basic scrutiny and is largely a "black box." (AEP Ohio Br. at 48-51.)
- EVA failed to calibrate the model or otherwise account for the impact of zonal rather than nodal prices. (*Id*. at 51-53.)
- EVA erred in forecasting LMP prices instead of using available forward energy prices. (*Id.* at 53-57.)
- EVA used inaccurate and understated fuel costs. (*Id.* at 57-60.)
- EVA failed to use correct heat rates to capture minimum and start time operating constraints and associated cost impacts. (*Id*. at 60-64.)
- EVA's static assumption of 26% shopping throughout the 2012-2015 period is flawed. (*Id*. at 64-65.)
- EVA failed to exclude from the analysis AEP Ohio's full requirements obligation to serve Wheeling Power Company. (*Id*. at 65-66.)
- EVA's estimate of gross margins that AEP Ohio will earn in the June 2012 through May 2015 period are overstated by nearly 200%, as shown by AEP Ohio witness Meehan's alternative calculation of forecast gross margins. (*Id*. at 66-69.)
- If an energy credit is used, it should reflect only the OSS margins created by "freed up" energy associated with the capacity being paid for by CRES providers. (*Id*. at 69-71.)
- Even setting aside whether only the OSS margins related to "freed up" energy sales should be reflected in the energy credit, EVA fails to reflect operation of the FERC-approved Pool in its inflated energy credit. (*Id*. at 71-76.)

Because AEP Ohio's Initial Brief expansively demonstrated the numerous flaws in EVA's energy credit, the failure to address each of those errors again in this Reply Brief should not be interpreted in any way as agreement with such errors. Rather, each of these major errors was fully documented and discussed in AEP Ohio's Initial Brief and need not be repeated here, as neither Staff's brief nor EVA's testimony refutes any of these points. There are only a few additional items mentioned in the initial briefs that AEP Ohio would like to provide an additional response to, in connection with the energy credit discussion.

1. While the Aurora model may be useful for certain types of analysis, EVA's application of the model in this case is inappropriate and produces a patently unreasonable result.

AEP Ohio has not argued that the Aurora model is fundamentally flawed. Rather, the problem is that Aurora is not well-suited for the task to which EVA has applied it. As an analogy, a long-term climate model may be useful in certain circumstances but no one would argue that is should be used to forecast the weather tomorrow or even next month. Moreover, the manner in which EVA has implemented the model is flawed. In particular, the choices that EVA made to implement the model, and the inputs that EVA selected, are in every observable respect biased towards inflating the gross margins that EVA uses the model to calculate. Company witness Meehan explained various respects in which EVA misapplied the Aurora model and, to the extent they were discernible, he described EVA's inappropriate assumptions and inaccurate inputs. (AEP Ohio Ex. 144 at 8-23.) Company witness Allen further supported the conclusion that the EVA witnesses had used inaccurate and biased input data that inflated the gross energy margins. (AEP Ohio Ex. 142 at 2-14.)

Staff in its brief claims that "The AURORAxmp was properly calibrated by EVA prior to the run it made for this case. EVA did multiple runs for another engagement prior to this case and conducted a sensitivity analysis using alternative gas prices, alternative coal prices, alternative emission allowances. As a result, EVA was able to spend a considerable amount of time looking at the results and assessing how accurate they were, and *EVA did make some* *changes as part of that review and analysis*." (Staff Br. at 60 (notes omitted).) Staff's brief also misapplies extemporaneous testimony Ms. Medine gave on the stand stating that the model had been run by EVA "dozens of times before it was run for this case." (*Id.*. at 59.) The simple fact that EVA repeatedly failed to accurately capture a simple and basic premise of the energy credit calculation – the plants owned by AEP Ohio – should cause the Commission to give little if any weight to the evidence presented by EVA's witnesses.

As a threshold matter, AEP Ohio submits that EVA's reliance on a secret government project that it was unable to discuss on the record should be completely disregarded for reasons of due process. Specifically, when she was asked during cross examination to discuss any supporting details or corroborate her statement, Ms. Medine declined saying that she is not allowed to talk about the secret government project she worked on. (Tr. X at 2210.) Ms. Medine's testimony that the model was pre-calibrated does not meet best industry practices. And as a basic matter of due process, the Commission must ignore Ms. Medine's incredulous claim that EVA's work on a secret government project purportedly honed the model for purposes of using it for AEP Ohio in this case, given that EVA refused to discuss or support its claim on the record.

In substance, the claim that EVA properly calibrated the model is simply not credible and distorts the record established in this proceeding. First, the activities performed in connection with the secret government project are falsely portrayed to imply that in the conduct of its work for ***this case*** EVA conducted sensitivity analyses using alternate fuel and emission allowance prices and spent considerable time "looking at the results and assessing how accurate they were." The transcript does not support that implication. The sensitivities conducted by EVA were done for a "confidential" federal government project and Ms. Medine was unable to provide any details with respect to the analyses. Further Ms. Medine did not provide a single fact concerning the assessment of how accurate that modeling was or even what metrics were examined. It is not even clear that EVA was assessing the accuracy of market price projections as Ms. Medine testified that EVA had acquired Aurora for a variety of analyses including projecting fuel burn volumes. Second, the Brief implies that EVA as part of ***this case*** "did make some changes as part of that review and analysis." There is no record support for that statement. The referenced changes to the database were made in the context of EVA's confidential federal government project and not for this case. That is simply unacceptable when it is essential in this case that accurate market prices for energy and fuel costs be properly developed for the AEP generating units. There is not even a hint that these items were among the results that EVA looked at and assessed the accuracy of.

Staff's brief (at 60) states that, "[i]t is EVA's position, after comparing the model's market prices against actual market prices, that its AURORAxmp model produces a justifiable LMP. EVA starts its analysis with actual prices and then they add to that understanding based upon being actively involved in buying and selling coal." This implies that EVA somehow starts with actual market prices and compares actual market prices against LMP and adds to the knowledge gained from that comparison. But that is not true if one goes back to the record. Staff improperly juxtaposes two different claims to create a false impression. First there is EVA's unsubstantiated statement that the model produces a justifiable LMP. Second, the above claim that EVA starts with actual prices and adds to that understanding based on being involved in buying and selling coal. In reality these statements are totally unrelated. The actual prices that EVA starts with are not LMPs, but are coal prices. EVA's analysis of coal prices done for another project that cannot be described has nothing to do with a comparison of actual market prices to the model's market prices nor anything to do with LMPs. In the absence of any calibration, Staff attempts to create an illusion of calibration by juxtaposing unrelated statements that create a false impression of what the record shows that EVA did and did not do.

EVA did not present a single piece of evidence to show that the model had been calibrated at all for the projection of LMPs in this case, let alone that the calibration was proper or sufficient. Without a carefully done analysis to produce nodal prices, any estimate of the revenue of AEP's generation resources is built upon a house of cards and cannot be relied upon by this Commission.

In sum, the claim that EVA sufficiently calibrated the model must be rejected for the following reasons:

- Staff did not present a single piece of quantitative evidence that compares EVA's model results to either historical LMPs or forward prices.

- In attempting to present EVA's calibration efforts in the best possible light, Staff as described above, has had to resort to mischaracterizing the record and presenting EVA statements out of context.

- The LMPs produced by EVA's AURORAxmp model are 8% above current forward prices at the AEP Dayton hub.

- An 8% overstatement in market prices will overstate gross margins by well over 20% all else equal, demonstrating an inadequate calibration.

- An adequate calibration is impossible as EVA only produced zonal prices. Ms. Medine testified that this was fine as there was no intra zonal congestion, but Mr. Meehan provided data showing that in fact there was significant intra zonal congestion and that the use of zonal prices is evidence of inadequate calibration.

(AEP Ohio Ex. 144 at 24-26.) The reality is that EVA's one full-time modeler (Mr. Harter) simply did not have time to properly calibrate the model (due to EVA's late date of engagement by Staff for this case) and consequently took unacceptable short-cuts in performing his work.

Another flaw related to use of a complex set of generic data without properly calibrating the results is EVA's use of the zonal mode of the Aurora model. Staff argues on brief that the results of zonal and nodal modeling are similar when there is not much congestion and there is not much congestion in the AEP Ohio zone. (Staff Br. at 51-52.) On cross exam, EVA admitted that it does not own the nodal version of the Aurora license but agreed that it more accurately modeled LMP prices as compared to the zonal version used by EVA. The nodal version is more expensive, and it takes more time to calibrate and longer to run the model. (Tr. X at 2280-82.) Mr. Harter used the zonal mode of Aurora, which is quicker and simulates only one price for the entire zone. He agreed that the nodal mode would produce more accurate results that are closer to the LMP price in a constrained market. (Tr. IX at 1865-66.) Ms. Medine could not confirm whether more than 10 RTOs are modeled; whether more than 10,000 generation units are modeled; whether more than 100 market zones are modeled; or how many transmission interconnection paths are modeled. (Tr. X at 2207-08.) Modeling that many factors using the zonal mode of the Aurora model is unduly complex and has resulted in multiple errors and indefensible results.

Staff also relies (at 47) upon the fact that NERA and AEP Ohio have used the Aurora model, including a discussion (at 62) where AEP Ohio's affiliate used it in a recent case in Kentucky, to suggest that EVA's use of the model here is appropriate. Regarding the general use of the Aurora model, AEP Ohio has repeatedly indicated that it is not challenging use of the model but merely objects to improper application of the model. In connection with the Kentucky case specifically, Staff attempts (at 63) to rely upon evidence presented before the Kentucky Commission to "contradict" AEP Ohio's demonstration that Staff's witnesses' energy prices are overstated.

As Mr. Allen testified, this notion is incorrect for the following reasons:

- The projected market prices were dated natural gas prices have declined significantly since the analysis was prepared. (Tr. XI at 2385.)

- Between the time the projected market prices were prepared and now, environmental regulations have changed with delays in new regulations. (*Id.*)

- The forecast prices focus on the period when the Big Sandy scrubber would be in service as evidenced by the following testimony, "what I do know is that it's a long-term forecast and that the focus of any forecast would have been on the years in which the Big Sandy Scrubber would have been operational which wouldn't have been 2012, 2013, 2014." (*Id.* at 2384.)

- The forecast is inappropriate to use for the short term as evidenced by the testimony that, "long-term commodity forecasts like this are developed based upon fundamentals for long-term analysis. Short-term analysis when there are forward prices available on the market, those forward prices are more appropriate to use." (*Id.* at 2384-85.)

- Long term prices are not liquid and traded, so of necessity the forecast needs to be developed in a different manner. (*Id.* at 2385.)

- Forward market prices are superior as they reflect the combined wisdom of all market participants as to what near-term power prices are going to be. (*Id.* at 2386.)

- For the application in Kentucky the short-term prices were not relevant and would have been developed using a fundamental model only for consistency purposes. This is explained by Mr. Allen:

  > When I look at an analysis like this I see that it's a 20-year forecast and you have a choice when you do a 20-year forecast like that you can either use two sets of data using forward market price curves for the near-term data and using fundamental analysis for the long-term period, or you can use a consistent methodology throughout. You can use a fundamental analysis through the entirety of the period because forward price curves don't exist for this 20-year period that we're talking about in Mr. Weaver's testimony. So for consistency he may have chosen to use a single methodology, especially in recognition of the fact that in the early years the Big Sandy Scrubber wouldn't be operational so the distinction between the forward-market price curves and the fundamental analysis may not be important to that analysis. (*Id.* at 2387.)

The only relevant point for the case at bar is that the analysis confirms EVA is, in fact, using dated gas prices in its analysis, thus overstating prevailing future market prices as confirmed by the published forwards.

Moreover, if Staff wants to raise inconsistencies from other cases, it should look to a much more related case pending before this Commission and involving the same Company (not an affiliate operating in a different State under different rules involving a completely different kind of case). In the Modified ESP case involving the same 2012-2015 time period Staff used to project an energy credit, Staff witness Johnson's testimony uses the PJM forward market to establish a lower energy price and a more restrictive MRO test. *See* Case No. 11-346-EL-SSO, *et al.*, Prefiled Testimony of Daniel R. Johnson (filed May 9, 2012) ("Johnson Modified ESP Testimony"). Thus, Staff committed a major substantive inconsistency by not using a forecast for the energy price component of the MRO test.[5] Staff's argument about consistency in the Kentucky case is a "red herring" argument that does not support what EVA did in this case.

Mr. Meehan further demonstrated the unsuitability of EVA's approach as a basis for establishing an energy credit. First, EVA's documentation is incomplete and inadequate. (AEP Ohio Ex. 144 at 13-14.) Second, the EVA model and the data it used cannot be reasonably verified. (*Id.* at 15-16.) Third, EVA's quality control measures are deficient. (*Id.* at 17-18.)

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[5] FES also argues that AEP Ohio's use of RPM pricing in its MRO test analysis as part of the *ESP I* proceeding provides support for the notion that RPM pricing should be used going forward in 2012-2015. (FES Br. at 7.) This notion is misguided. The use of an RPM pricing assumption was accurate for 2009-2011 because it was the actual capacity price charged during that entire period. And because AEP Ohio's proposed SSO rates were so low and there was headroom under the MRO test even using the RPM capacity pricing, it was a conservative and simplifying assumption. There is no reason why that historical fact should constrain the terms of the future ESP or the prospective capacity charge to be established in this proceeding. By contrast, Staff's use of (lower) forward pricing in the MRO test and (higher) projected pricing in the energy credit for the same time period cannot be reconciled.

Fourth, even if the EVA methodology were acceptable, the execution of the analysis contains significant errors and has not been performed with requisite care. The approach cannot be adequately tested or validated. (*Id.* at 18.) Consequently, EVA's modeling cannot be relied upon by the Commission.

Alternatively, AEP Ohio's method for the energy credit uses historical PJM prices along with energy and fuel costs from its FF1 that are available to all parties. Consequently, the Company's methodology for an energy credit (if one is chosen by the Commission) is both verifiable and auditable. This provides a choice for the Commission between a "black box" in EVA's approach and an "open book" approach in the case of AEP Ohio's method. If the Commission does alternatively choose a forward-looking methodology, then at least Mr. Meehan's methodology utilizes verifiable forward prices and AEP Ohio's best estimates of its future fuel and energy cost.

2. Staff's additional arguments on brief attempting to support EVA's overstated energy prices and understated costs are without merit.

Staff's position is (at 60) that the model "produces a justifiable LMP." Staff suggests that forward prices are volatile and relies upon Staff Ex. 106 to show that there were substantial changes in the forward prices between December 29, 2011 and January 5, 2012. Staff's use of this exhibit is misleading and it does not support Staff's position. It is misleading because, while Staff did not disclose this fact in presenting the information, it must have known that the two dates chosen by Staff straddled an important legal development that had a material impact on short-term projections of energy prices. As AEP Ohio witness Allen testified, the Federal Court of Appeals for the D.C. Circuit issued a stay order on December 30, 2011, such that the CSAPR regulations would no longer be implemented as originally planned. (Tr. XI at 2460.) Mr. Allen indicated that the market's quick incorporation of this development confirms his position that the forward prices reflect environmental risks and costs. (*Id*.) As to Staff's contention that Exhibit 106 demonstrates volatility, there are two obvious problems with that flawed observation. First, because the D.C. Circuit stay order was a significant and unusual event, the change experienced between the two data points on the exhibit is not typical or representative of recurring volatility. Second, Mr. Allen stated the obvious that nothing about volatility can be accurately observed through only two data points. (*Id.* at 2459.) Even if forward prices are volatile, that does not mean they are inaccurate – and Staff was willing to accept any volatility in applying the MRO test as part of the ESP case. Staff's presentation of Staff Exhibit 106 is disingenuous and its reliance on the exhibit is unavailing. The exhibit does make the point that the forward market immediately incorporates new information and moves the price based on the collective knowledge of the market regarding the resulting impact of the event on future prices. A forecast model, on the other hand, can only include the impacts of such events after the model and the forecast are modified by the modeler. Such modification will also be constrained based on the level of information utilized by, and the expertise and knowledge of, the modeler and the limitations of the model itself.

Staff also argues (at 63) that Mr. Allen acknowledged from Staff Exhibit 108 (EIA Short-Term Energy Outlook, released May 8, 2012) that EIA forecasts the average delivered coal price in 2012 will be 2.8% lower than the 2011 average price, and the average delivered coal price in 2013 will be 3.8% lower than 2012. Staff suggests that this outlook supports Ms. Medine's modeled forecast and analysis with respect to coal prices. On the contrary, the forecasted drop in coal prices are for *spot purchases*, and AEP Ohio already has contracts in place for most of its coal needs. (Tr. XI at 2430-2431.) Staff Exhibit 108 does not in any way lend credibility to EVA's grossly understated fuel costs. By contrast, Ms. Medine herself admitted that the gas prices she used in developing the energy credit were already outdated and that EVA has, in fact, revised its projected gas price downward since the time it only recently performed the Aurora modeling; while Ms. Medine could not recall the particulars, EVA's updated gas price projection is consistent with the EIA downward forecast referenced AEP Ohio Ex. 141. (Tr. X at 2277.)

Staff also claims (at 63) that AEP Ohio's argument opposing Staff's energy credit to offset the capacity price is inconsistent with how PJM calculates a capacity rate. Gross CONE (gross cost of new entry) is the benchmark for building a new simple-cycle unit. To calculate net CONE, PJM makes an energy and ancillary services adjustment to gross CONE. Staff asserts that EVA's methodology in this regard is the same as PJM's. Staff is wrong. PJM does the opposite of what EVA did. PJM uses a historical energy and ancillary credit, rather than a projected future credit, as an offset to forecasted demand (fixed) costs of building a new peaker. (FES Ex. 110C at 44, Net Energy and Ancillary Service Revenue Offset, Att. DD, § 5.10.v.A; FES Ex. 101 at Exhibit RBS-4, pp. 147-149.) It is a fallacy for Staff to claim that EVA's method aligns with PJM's. Indeed, it is AEP Ohio's energy credit method that utilizes historic energy prices for its energy credit calculation, and as a result, is similar to PJM's use of historic, rather than future, prices for its energy and ancillary service adjustment.

As AEP Ohio explained comprehensively at pages 45-63 of its Initial Brief, Staff's methodology included other material errors resulting in significant overstatements of the energy margins that AEP Ohio could realize, including, *inter alia*, understated fuel costs for coal units, understated heat rates for gas units, overstated market prices, and failing to recognize the Wheeling Power contract. AEP Ohio reincorporates those points as if fully restated herein.

3. Staff's static shopping assumption of 26% is not "conservative" and, in any event, is unreasonable.

Staff maintains (at 55) that in using a static 26% shopping assumption EVA "chose to be conservative … for the reason that EVA did not forecast whether shopping would go up or down over the next three years." This is not conservative in the sense that it favors AEP Ohio, because shopping levels are already higher than that even though both tiers of capacity pricing are higher than Staff's proposed capacity charge. (AEP Ohio Ex. 142 at 21 (AEP Ohio witness Allen noting that, as of April 30, 2012, shopping levels were already at 30%).) It is hollow and disingenuous to argue that EVA is being generous by assuming that shopping will not go down.

Regarding the Company's projected shopping levels, FES argues (at 24-25) that Mr. Allen's projections of shopping are unrealistic; yet, FES contradicts itself by also stating (at 55-56) that RPM will consistently produce headroom for all customers and that competitive forces will pass along optimal savings to customers. The reality is that RPM will produce swift and high levels of increased shopping, a fact with which numerous witnesses agreed. (*See* Tr. VIII at 1561-1562 (Exelon witness Fein testifying that at $146/MW-Day Exelon could "of course" make offers that would be attractive to shopping customers). *See also* Tr. III at 710-711; AEP Ohio Ex. 104 at 6 (AEP Ohio witness Allen noting that 6.8% of the total AEP Ohio load switched at $255/MW-Day and that additional shopping would occur at lower energy prices).) This, as demonstrated above and in the Company's Initial Brief, will necessarily result in substantial financial harm to AEP Ohio unless there is a mitigating rate mechanism.

4. The FERC-approved Pool must be fully reflected in any energy credit.

FES also claims (at 43) that CRES providers are captive customers for capacity service and should receive 100% credit for all OSS margins. FES argues (at 43) that there is no sound basis for not crediting all OSS margins against the demand charge. The Pool, though, does not distinguish between OSS margins related to freed up energy from shopping load and any other kinds of OSS margins produced. As demonstrated in the Company's Initial Brief, neither FES's nor EVA's approach reflects actual operation of the Pool. (*See* AEP Ohio Br. at 71-76, *citing* AEP Ohio Ex. 142 at 8-14.) It is not lawful for the Commission to disregard the correct operation of the FERC-approved Pool.

Staff suggests (at 64) that EVA's OSS margin projection was somehow justified because AEP Ohio witness Allen declined to characterize as a subsidy the crediting of 100% of OSS margins to retail customers in West Virginia. It is a gross error to compare West Virginia's retail cost of service credit based on OSS margins to the energy credit calculation made by EVA in this case: the subsidy problem in this case arises from below-cost rates. The West Virginia retail customer pricing is based on traditional rate base/ rate of return rates and reflects 100% of power plant costs, where there is no shopping or associated risks. EVA applies the Pool incorrectly in this case and creates a subsidy from non-shopping customer margin being credited to the benefit of CRES providers (who may or may not pass that subsidy along to shopping customers). In any case, Staff's thinly-veiled selective citation of West Virginia should be ignored; regarding the OSS margins actually retained under the Pool by AEP Ohio, there should be a sharing, at best, not a total confiscation of OSS margins to be reflected in an energy credit. The evidence showed that all of the other regulatory jurisdictions in the AEP East operating companies' service territories utilize OSS margin sharing. (RESA Ex. 103.) Otherwise, AEP Ohio's retail non-shopping customers will be disadvantaged over CRES customers.

Staff claims (at 53-55) that EVA's treatment of OSS is conservative because it only considers AEP Ohio's margins and does not include OSS margins received from other member companies. This is speculative and false, as Staff admitted that it does not account for primary sales to other Pool members, which are made at cost and which reduce the volume of energy available to produce OSS margins that could possibly be allocated to AEP Ohio under the Pool. Staff has also not excluded Wheeling Power energy sales, which are also made at cost, from its calculation of the energy credit – this is yet another flaw that inflates the energy credit calculation. Staff's unsupported assertion that its treatment of OSS margins is conservative should be disregarded.

In reality, EVA erroneously converted the gross energy margins (which were already vastly overstated) to the amount retained by AEP Ohio. Specifically, EVA failed to reflect how the Pool Agreement limits the extent to which gross margins are retained by AEP Ohio and, thus, are available to support an energy credit. (AEP Ohio Ex. 143 at 6-14; AEP Ohio Ex. 142 at 4.) As described in the testimony of AEP Ohio witness Nelson, EVA's failure to properly recognize the impact of the Pool Agreement manifests itself in EVA's assumption that the energy margins that it imputes to non-shopping SSO load would be retained 100% by AEP Ohio and should be used in their entirety to offset costs of capacity used to serve CRES providers. Mr. Nelson explained that, through this imputation of SSO energy margins and the assumption that the imputed margins are retained 100% by AEP Ohio, EVA improperly converted the Member Load Ratio (MLR) for AEP Ohio from 40% (real world under the FERC-approved Pool) to 92% (fictional world that only exists in EVA's testimony). (AEP Ohio Ex. 143. at 10.) In substance, this flawed method confiscates revenues from AEP Ohio's retail SSO sales and uses them to subsidize CRES providers through a lower wholesale rate that they pay to AEP Ohio for capacity. (AEP Ohio Ex. 143 at 6,11.) Of course, this fictional imputation and retention of energy margins further, and substantially, inflates AEP Ohio's retained energy margins and, ultimately, EVA's proposed energy credit.

Finally, regarding the Pool, FES argues (at 43) that AEP Ohio cannot rely on the Pool because the agreement can be changed with 90 days notice. This argument is without merit. First, AEP Ohio is not the only member of the Pool and it cannot unilaterally implement changes based on factors that would uniquely benefit AEP Ohio and operate to the detriment of other members. Second, there is no reason that AEP Ohio would pursue changes that would result in financial harm to AEP Ohio. Third, any changes proposed by AEP Ohio need to be approved by the FERC and would likely be litigated in a protracted proceeding involving numerous parties. Pool modifications have been a lengthy process. The last modification resulted from the acquisition of CSP and was about thirty years ago. The reality is that the Pool members are already pursuing termination of the agreement and that process will move forward in due course; the Pool exists today and the Commission cannot assume it away as FES contends.

5. There are more moderate options for the Commission to consider adopting beyond the disparate energy credits calculated by AEP Ohio witness Dr. Pearce and Staff witness Medine.

Beyond the two ends of the spectrum between Dr. Pearce's energy credit calculation of $17.56/MW-Day (AEP Ohio Ex. 102 at Ex. KDP-6) and Ms. Medine's energy credit of $152.41 (Staff Ex. 105 at Ex. ESM-1), there are other more moderate options that the Commission may consider adopting in this case. AEP Ohio witness Allen summarized his adjustments to EVA's energy credit in his testimony as follows:

	($/MW-Day)
Medine's Energy Credit	**152.41**
Understated Fuel Cost for Coal Units	(70.10)
Understated Heat Rate for Gas Units	(1.87)
Overstated Market Prices	(50.42)
Failure to Recognize Wheeling Power Contract	(5.00)
Cross Impact of Fuel and Market	22.44
Energy Credit after Adjustments	**47.46**

(AEP Ohio Ex. 142 at 14.) Accordingly, if EVA's testimony is to be relied upon at all, then its energy credit should be corrected to be $47.46/**MW-Day**.[6] These adjustments to Staff's energy credit could be made individually or in combination to the extent that the Commission agrees with the basis for each adjustment. The calculations in Mr. Allen's table alone provide several alternatives to the bookend choices.

Moreover, AEP Ohio witness Nelson provided additional options for an energy credit calculation in his rebuttal testimony, AEP Ohio Ex. 143:

- Using Staff's methodology and applying shopping levels that are different than the Staff's static assumption of 26%, Mr. Nelson calculated three additional alternatives of $125/MW-Day, $96/MW-Day and $67/MW-Day. (AEP Ohio Ex. 143 at 12.)

- Using a cost-of-service methodology and applying various shopping levels, Mr. Nelson calculated four additional alternatives of $23/MW-Day, $47/MW-Day, $59/MW-Day and $65/MW-Day. (*Id.* at 13.)

- Using an average rate methodology, Mr. Nelson calculated an additional alternative of $66.47/MW-Day. (*Id.* at 13.)

- Using AEP Ohio witness Meehan's more accurate calculation of gross energy margins, Mr. Nelson calculates three additional "no Pool" alternative calculations of $73.24/MW-Day ($29.62/MW-Day after applying the 40.45% MLR), $64.18/MW-Day ($25.96/MW-Day after applying the MLR) and $58.11/MW-Day ($23.50/MW-Day after applying the MLR). (*Id.* at 17.)

While some of Mr. Nelson's alternative calculations are more valid than others, as further explained in his testimony, his robust analysis provides several alternatives that are all more

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[6] AEP Ohio notes that EVA and Larkin are currently auditors in the Company's Fuel Adjustment Clause proceedings. Ms. Medine relied on her knowledge and experience obtained through her auditing role in developing her testimony and believes that her experience as a fuel auditor adds credibility to her testimony. (Tr. X at 2135-36.) Leaving aside the potential issues relating to EVA/Larkin flipping back and forth between being advocates against the Company in adversarial proceedings one day and being an auditor the next, AEP Ohio submits that the Commission should not extend any deference to EVA and Larkin in this case – separate and apart from the fact that the testimony is full of errors.

reasonable than EVA's $152/MW-Day energy credit. He demonstrated that the various methods converge around $66/MW-Day for an energy credit. (AEP Ohio Ex. 143 at 8.)

Finally, while it is not developed in the record in this case, the Commission also has the option of directing Staff to calculate an energy credit that is consistent with the forward prices being advocated by Staff for use in the MRO price test as part of AEP Ohio's Modified ESP proceeding. (*See* Staff Ex. 102, May 9, 2012 testimony of Daniel R. Johnson, Case Nos. 11-346-EL-SSO at 2-4 and Attachment DRJ-5.) As it did in the *ESP II* Stipulation proceeding, Staff uses simple swap prices based on actual forward contracts for energy in applying the MRO price test. It is inappropriate for Staff to use higher projected energy prices when calculating an energy credit in this case (which reduces the price to be collected from CRES providers for capacity) while simultaneously advocating different and lower forward energy prices for the MRO test (which can operate to reduce the price to be collected from retail SSO customers). Aside from Staff's projected energy prices being different, AEP Ohio submits that the approach advocated by Staff witness Johnson in the ESP II cases more accurately reflects projected energy prices and EVA's approach here does not.[7] AEP Ohio estimates that this approach would reduce Staff's energy credit, while otherwise using EVA's method, by approximately $50/MW-Day.

[7] Staff witness Johnson has consistently used simple swap prices, as published by the Intercontinental Exchange or Platts, and has stated that such forward market prices are prices at which transactions have actually taken place for the future period under review. (*Modified ESP*, Tr. VIII at 2467; Johnson Modified ESP Testimony; Johnson ESP 2 Stipulation Testimony (Aug. 4, 2011); Johnson ESP 1 Testimony, Case Nos. 08-917, *et. al*. (Nov. 10, 2008).) Mr. Johnson has never taken issue with the use of such forward market prices in the Company's ESP cases and has only updated data by choosing a more recent date(s) for the swap prices. Referring to simple swap prices, he states that "Respondents to a request for proposals or bidders in an auction would use the most recent quotes available because the most recent quotes would be the best estimates of the prices they could hedge." (Johnson Modified ESP Testimony at 29.) Mr. Johnson has also concurred that the simple swap prices and the forecasted energy prices that Medine-Harter developed are both supposed to represent the market price of energy over the period (*Modified ESP*, Tr. VIII at 2489).

C. Staff And Intervenors' Proposals For A Cost-Based Demand Charge Are Significantly Understated.

1. Staff witness Smith eliminated some costs included in Dr. Pearce's calculations, and made unwarranted downward adjustments to other costs, despite Dr. Pearce's use of a formula rate template approved by FERC.

At pages 77-81 of its Initial Brief, AEP Ohio explained why Staff witness Smith went astray in proposing several significant downward adjustments to Dr. Pearce's capacity cost calculations, which were based on an approach previously approved by FERC in the Minden/Prescott wholesale capacity transactions. AEP Ohio incorporates those arguments again here as if fully rewritten. In its Initial Brief, AEP Ohio noted, among other things, that without providing a satisfactory reason for doing so, Mr. Smith conceded that he affirmatively chose to deviate from Dr. Pearce's FERC-approved formula rate template on the tenuous basis that "'We're not at the FERC. We are at the PUCO and a lot of stuff does appear to be very inconsistent with standard regulatory practices here.'" (AEP Ohio Br. at 79, quoting Tr. IX, 1978.) Respectfully, the Commission should require more compelling and persuasive rationales than those offered by Staff's consultant to justify departing from the formula rate template that FERC has previously and recently approved in the context of wholesale capacity transactions, after "heavy regulatory review from FERC staff." (Tr. II at 251.)

Notably, although its initial brief is lengthy, Staff there provides no new clues about the reasons underlying Mr. Smith's many downward departures from Dr. Pearce's FERC-approved formula rate template. Although Staff devotes nearly 40 pages of its Initial Brief to Mr. Smith's various downward adjustments, those 40 pages contain not a single citation to any live hearing testimony from Mr. Smith himself (or any other hearing witness) supporting the specific adjustments that Mr. Smith proposed in his written testimony. (*See, generally,* Staff Br. at 9-46.)

Instead, Staff's initial brief in this regard is merely a re-hash (frequently verbatim) of Mr. Smith's prefiled testimony.

Staff made no attempt at the hearing to re-direct Mr. Smith after he was cross-examined about his various adjustments (Tr. IX at 1930-2056), and Staff similarly made no effort in its initial brief to address any of the points challenging Smith's adjustments that had been elicited on cross-examination, or in the rebuttal testimony of AEP Ohio witnesses, Messrs. Allen and Nelson. And although more than a dozen post-hearing briefs have been filed in this case, only AEP Ohio addressed the merits of Mr. Smith's individual adjustments – not a single Intervenor devoted any space in their initial post-hearing briefs to justifying the specific adjustments proposed here by Staff's consultant. Without citation to any supporting authority, IEU merely described Mr. Smith's adjustments collectively as being ones "that would be required if AEP-Ohio's formula rate were reviewed under traditional cost-based ratemaking." (IEU Br. at 34 (emphasis added).) As IEU itself must concede, given its oft-repeated challenges to this Commission's jurisdiction, this proceeding hardly qualifies as "traditional." In any event, instead of being adjustments consistent with traditional cost-based ratemaking, several of Mr. Smith's adjustments are actually *inconsistent* with the treatment of the same cost categories by this Commission and the FERC in prior rate cases.

For the reasons described below and in AEP Ohio's Initial Brief, the Commission should correct a fundamental error in the Smith/Harter approaches that would, if adopted by the Commission, result in nearly $66.5 million in "trapped costs" and should reject several of the misguided adjustments that Mr. Smith proposes to Dr. Pearce's FERC-approved formula rate approach for calculating AEP Ohio's cost of capacity, including his downward adjustment to ROE, his unwarranted eliminations of both severance costs and the Company's prepaid pension asset, and his wholesale exclusions of both CWIP and cash working capital. These adjustments by Staff's consultant understate AEP Ohio's actual costs of capacity, diverge from prior Commission- and FERC-approved practice, and appear to be adjustments that were made not for the purpose of truly reflecting AEP Ohio's actual costs, but instead for the purpose of reducing the capacity rate. (Tr. IX, 1984) (Mr. Smith testifying on cross-examination that Dr. Pearce's "rate was too high and these adjustments need to be made.")

2. Staff witness Smith and Harter's approaches result in nearly $66.5 million in "trapped costs," which costs were ignored by Mr. Harter (and thus not netted against the energy margins he calculated), yet also excluded from Mr. Smith's capacity calculations.

At pages 81-82 of its Initial Brief, AEP Ohio demonstrated why Mr. Smith's failure to consider the effect of nearly $66.5 million in certain energy costs – coupled with Staff witness Harter's failure to reduce his energy margin calculation by the amount of those energy costs – resulted in Mr. Smith's proffered capacity charge being *understated* by $20.11/MW-Day on a merged AEP Ohio basis. AEP Ohio incorporates those arguments again here. AEP Ohio witnesses Messrs. Nelson and Allen both testified in rebuttal about these trapped costs, in written testimony and in-person at the hearing. (AEP Ohio Ex. 142, 143; Tr. XI, 2311, 2563.)

Staff cross-examined Mr. Allen about his rebuttal testimony at hearing, but never challenged Mr. Allen's calculation of trapped costs. (Tr. XI, 2407-56.) And Staff did not cross-examine Mr. Nelson about his rebuttal testimony at all, much less to dispute the table in Mr. Nelson's rebuttal testimony depicting the values of the trapped costs that were improperly excluded by Staff from *both* the capacity *and* energy sides of Staff's calculations. (Tr. XI, 2479-2577.) Only IEU made a half-hearted effort to challenge Mr. Nelson on the trapped cost issue at hearing – an effort that Mr. Nelson quickly and easily rebuffed:

Q. And no trapped costs either?

A. Now, we just discussed the trapped costs.
Q. So in your view there's no trapped costs
raised by the staff's energy margin calculation?
A. No, that's not what I said. I described
why there is trapped costs.
Q. Okay.

(Tr. XI at 2563.) Accordingly, to avoid improperly "trapping" nearly $66.5 million in energy costs, the Commission should adjust the capacity rate that Mr. Smith proffered on behalf of Staff as Mr. Allen and Mr. Nelson described in this unchallenged portion of their rebuttal testimony. As Mr. Allen testified:

> If you start with a capacity cost of $325.59/MW-Day and subtract an energy credit of $47.16/MW-Day and ancillary service revenues of $6.66/MW-Day, the resultant capacity rate would be $271.47/MW-Day. *Adding in the trapped cost of $20.11/MW-Day described by Company witness Nelson, the capacity rate would be $291.58/MW-Day*.

(AEP Ohio Ex. 142 at 18; Tr. XI at 2311 (emphasis added).)

3. Other specific adjustments that Staff witness Smith made to Dr. Pearce's cost calculations inappropriately understate AEP Ohio's costs and contradict the Commission's prior orders and practices, as well as those of FERC

a. Mr. Smith's downward adjustments to ROE from 11.15% to 10.0% (CSP) and 10.3% (OPCo) were simply plucked from a negotiated stipulation in a distribution rate case, and Mr. Smith agreed that the generation business faces risks that the distribution business does not face.

Staff devotes less than a single page of its initial brief to re-hash in a block quotation the erroneous proposal in Smith's prefiled testimony that the Commission should apply a 10% return on equity ("ROE") for CSP and a 10.3% ROE for OPCo. (Staff Br. at 9, *quoting* Staff Ex. 103 at 12.) In its brief, Staff contends that the ROEs used and recommended by Witness Smith are the "most current as applied to AEP Ohio in Commission cases" and that they "must" be applied here. (*Id.*) Staff fails to provide any authority for the proposition in its initial brief that ROEs *resulting from a negotiated stipulation* in a *distribution rate case* "must" be applied here in this separate investigatory proceeding. Staff's omission of supporting authority for this proposition is understandable, because there is no such authority known to AEP Ohio requiring a *negotiated* ROE value from a rate case to be applied in all future, unrelated proceedings, such as this Commission-initiated investigation into wholesale capacity charges.

For the reasons described at pages 83-85 of AEP Ohio's Initial Brief, and in the rebuttal testimony of AEP Ohio witness Allen (AEP Ohio Ex. 142), it was inappropriate for Mr. Smith to adjust Dr. Pearce's 11.15% ROE value substantially downward for the riskier *generation* side of the Company's business, based on negotiated "consensus" values that he obtained from a stipulation in *distribution* rate cases, particularly given that Mr. Smith admitted on cross-examination that the generation business faces substantially greater risks than the distribution side is ever likely to confront. (Tr. IX at 1991-1993.)[8] Mr. Allen noted in his rebuttal testimony that "[t]he Commission has most recently recognized an ROE of 10.5% for certain generating assets of AEP Ohio" (AEP Ohio Ex. 142 at 17-18), and this testimony was unchallenged on cross examination, where Mr. Allen also noted that "[t]ypically the ROEs that the Company has requested in the other jurisdictions has been *in the 11 plus percent*" range." (Tr. XI at 2392 (emphasis added).) The Commission should reject Mr. Smith's unreasonably aggressive downward adjustment to ROE and retain the 11.15% ROE value utilized by Dr. Pearce. At the very least, in the alternative, the Commission should adopt the 10.5% ROE that it has recognized

[8] The Commission need look no further than the evidence presented in this case that generation is riskier, and is made that way by Staff's own testimony. Staff witness Medine developed an energy credit based on forecast prices that do not reflect current forward prices for that future period, yet *de facto* maintains that those higher prices are what AEP Ohio's generation will be able to obtain in the future. Consequently, AEP Ohio generation has clear exposure that it can't currently hedge in any way, as it might be able to do to some extent (excluding the risks of unknown switching levels) if the future prices as presented by Company witness Meehan were utilized.

recently for certain generating assets of AEP Ohio. (Tr. III at 581 (Mr. Allen testifying that "a reasonable return on equity in today's environment is in the 10 to 12 percent range" for an electric utility).)

If the Company is unable to earn a reasonable ROE, the Company will be forced to transfer wealth from its own shareholders to competitor CRES providers. As Mr. Allen stated, "this isn't a free lunch" and the money that would subsidize CRES providers would have to come from somebody. (*See* Tr. III at 704.) And as a direct result of a less-than-compensatory ROE, the shareholders of AEP would be affected, as both individual pension funds that hold AEP stock and individual investors would be negatively impacted by the significantly reduced profits that would flow through AEP. (*Id.* at 673.)

b. Mr. Smith's elimination of certain severance costs is contrary to treatment of the same costs by the Commission.

In its initial brief, Staff persists in proposing that severance costs should be excluded from the O&M expense allocated to the generation demand function under Dr. Pearce's formula rate. (Staff Br. at 32-37.) Again, Staff quotes verbatim from Mr. Smith's prefiled testimony on this issue, without acknowledging (much less overcoming) Mr. Allen's rebuttal testimony on this point. (*Id.* at 33, quoting Staff Ex. 103 at 46-47). As AEP Ohio explained at pages 85-87 of its Initial Brief, which is incorporated fully by reference here, this adjustment by Mr. Smith improperly understates AEP Ohio's costs and is inconsistent with the Commission's prior treatment of severance costs.

As Mr. Allen explained succinctly in his rebuttal testimony, "[t]he severance costs were properly recorded as O&M expenses in 2010 and the benefits associated with the severance program will be reflected in future annual updates to the formula based capacity cost calculation presented by Company witness Pearce." (AEP Ohio Ex. 142 at 16.) Moreover, Mr. Allen noted that in AEP Ohio's most recent distribution rate cases (11-0351-EL-AIR & 11-0352-EL-AIR), the Staff recommended that 50% of the cost of the severance program be amortized over a period of three years. (*Id.*) At hearing, counsel for Staff tried to challenge Mr. Allen regarding the purposes of the severance program, and also tried to get Mr. Allen to admit that the payroll savings realized by the Company "have been more than sufficient for AEP to have fully amortized the severance costs," but Mr. Allen fully addressed both of these points in testimony that Staff fails to acknowledge in its initial brief. (*See* Tr. XI at 2439-2443.)

Mr. Smith himself conceded in his written testimony that the severance cost "perhaps" should be amortized. (Staff Ex. 103 at 46.) The Commission should do that here, in order to be consistent with its treatment of severance costs in AEP Ohio's most recent distribution rate cases, instead of looking to Virginia (as Mr. Smith did, and as Staff does in its brief, at 34-36) for the approach to follow here. Amortizing the $39.004 million in severance costs that Mr. Smith removed from O&M expense over three years would increase Mr. Smith's proffered capacity rate by $4.07/*MW-Day*. (AEP Ohio Ex. 142 at 17.)

c. Mr. Smith's elimination of prepaid pension expenses differs from the Commission's treatment of the same cost categories in the Company's distribution rate case, and his justifications for the different treatment do not stand up to scrutiny.

In its initial brief, Staff admits that "[i]n the Staff Reports in CSP's and OPCo's last distribution rate cases, *Staff ... increased rate base to recognize a prepaid pension asset*." (Staff Br. at 16 (emphasis added).) Yet now, in its relentless attempts to artificially adjust AEP Ohio's costs of capacity in a negative direction, Staff calls it "improper" for AEP Ohio to propose to include a prepaid pension asset here in this proceeding. (*Id.* at 15.) Staff's newly minted position regarding treatment of a prepaid pension asset can only be described as perplexing, particularly given the difficult time that Staff experienced in cross-examining Mr. Allen on this issue at hearing. As Mr. Allen explained to Staff counsel on cross-examination:

> the prefunding of a pension does result in reduced costs going forward and *that's why prefunded pension is included in rate base typically, because it's an investment made by the Company that produces cost savings that are passed on to customers in the future*.

(Tr. XI at 2447-48 (emphasis added).) This concise explanation of the basis for including the prepaid pension asset in rate base was followed by this exchange between counsel for Staff and Mr. Allen, clearly reflecting Staff's confusion on the issue:

> Q. AEP Ohio has not reflected any reductions in pension expense, has it?
> A. In 2010, the prepaid pension asset that was on the Company's books would have resulted in lower pension expense in 2010 than would have existed in the absence of that prepaid pension. *So we have reflected lower pension expenses.*
> Q. Has -- AEP Ohio has not reflected any pension cost savings, has it?
> A. *Yes, they have. That's what I just indicated* is that the prefunding of the pension does result in reduced costs that would have been reflected in the actual pension expense booked by the Company in 2010.

(*Id*. at 2448.) Abandoning this unfruitful line of inquiry, and perhaps mindful of how Staff most recently treated the Company's prepaid pension asset *here in Ohio*, counsel for Staff next began asking Mr. Allen about how the Company's prepaid pension asset had been treated *in Virginia*. (*Id.* at 2448.) Staff's brief, although it devotes several pages to the prepaid pension asset issue, does not address any of Mr. Allen's rebuttal testimony or any of the issues that he raised in his cross-examination. (Staff Br. at 16-21.)

Instead, Staff provides in its initial brief three baseless justifications for failing to include the prepaid pension asset here – the same justifications that appeared in Smith's prefiled testimony. First, Staff asserts that AEP has failed to demonstrate that it actually has a net prepaid pension asset. (*Id.* at 17, *quoting* Staff Ex. 103 at 24.) Notably, Staff repeats this assertion from Mr. Smith's written testimony even though Staff never cross-examined Dr. Pearce about the prepaid pension values appearing in his formula rate. (Tr. II 337-348.) In any event, Mr. Smith is completely wrong about this factual assertion, because he is confusing the Company's net funded position (which is a liability) with the FAS 87 prepaid pension *asset*, which is computed using different components. The prepaid pension asset is equal to the cumulative amount of cash contributions to the pension trust fund in excess of cumulative periodic pension cost, and this value appears in the Account (1650010) that was included in Dr. Pearce's formula rate and duly produced by AEP Ohio in discovery. The prepaid pension asset value appearing in Dr. Pearce's formula rate is thus indeed supported by verifiable data in Staff's possession.[9] Next, Staff asserts that because pension funding levels are the result of "discretionary AEP Ohio management decisions," that somehow makes the prepaid pension asset unfit for capacity rate base. (Staff Br. at 18-20.) But Staff provides no legal support or precedent for the concept that "discretionary" investments cannot be included in rate base. The fact that a pension funding level may be "discretionary" is no basis to treat the prepaid pension asset in this proceeding any differently than Staff treated the very same "discretionary" pension funding cost in the Company's most recent distribution rate cases. Finally, Staff blames AEP Ohio for failing to provide a lead-lag study related to the prepaid pension asset – an issue addressed below with respect to Mr. Smith's elimination of cash working capital on the same basis.

[9] Tab 5c of Dr. Pearce's workpapers includes the following values from AEP Ohio's 2010 FERC Form 1: CSP – $127,936.031; OPCo – $187,443,029.

For these reasons and those stated at pages 88-89 of AEP Ohio's Initial Brief, which are reincorporated fully herein, Mr. Smith clearly erred by excluding the prepaid pension asset from his proffered capacity charge rate. The Commission should reject this adjustment and include the prepaid pension asset (net of ADIT) of $96.116 million in rate base, which would increase the capacity charge rate proffered by Mr. Smith by $3.20/MW-Day. (AEP Ohio Ex. 142 at 16.)

d. Mr. Smith should not have excluded CWIP from rate base.

In its initial brief, relying on a statutory requirement that does not directly apply in this investigatory proceeding,[10] Staff posits that CWIP should be excluded from Dr. Pearce's formula capacity rate. (Staff Br. at 10-11.) Again, Staff makes this proposed adjustment to Dr. Pearce's formula rate by relying solely on Mr. Smith's prefiled testimony, without having cross-examined Dr. Pearce about the CWIP issue at the hearing that occurred only days after Mr. Smith's written testimony was filed. (Tr. II at 337-348.) Nor does Staff address in its post-hearing brief the compelling points that AEP Ohio witness Allen raised both in his written *and* oral testimony regarding the inequities that will result if the Commission agrees with Smith and excludes CWIP from the capacity charge.

In his rebuttal testimony, Mr. Allen explained that non-environmental CWIP relates to investments that are made "to maintain the long-term operability of the generating fleet, and as

[10] Staff cites R.C. 4909.15 for the proposition that the Commission, in its discretion, may include a reasonable allowance for CWIP, "but in no event may such allowance be made by the Commission until it has determined that the particular construction project is at least seventy-five percent complete. It also states no allowance for CWIP shall be in rates for a period exceeding 48 months and any sums of money that the Company may have received must be given back to the customers once the property is used and useful in service." (Staff Br. at 10, *citing* R.C. 4909.15.) This proceeding was not commenced by AEP Ohio pursuant to R.C. Chapter 4909, but rather by the Commission invoking its authority to supervise and regulate public utilities under R.C. 4905.04, .05, and .06. *See* Case No. 10-2929-EL-UNC, Entry at ¶ 2 (Dec. 8, 2010).

such, individual CRES providers that are utilizing that capacity should pay for the carrying cost on those." (Tr. XI at 2446.) As for environmental CWIP, Mr. Allen testified:

> Although Staff witness Smith makes several claims regarding the exclusion of CWIP from rate base he fails to recognize that the Company has recovered carrying costs on environmental CWIP through the [EICCR]. The EICCR is collected through current [SSO] rates. *Including, at a minimum, CWIP on environmental investments in rate base would ensure that all customers utilizing the Company's capacity resources, SSO customers and CRES providers, are treated similarly*.

(AEP Ohio Ex. 142 at 14 (emphasis added).) Mr. Allen emphasized the same points on cross-examination, testifying that "[n]onshopping customers pay for environmental investments through the EICCR, and CRES providers and their customers will pay for those same environmental investments on those same plants through the capacity charge." (Tr. XI at 2446.) There has been no response from Staff – either by way of cross-examination or argument in its initial brief – to these fundamental points relating to CWIP raised by Mr. Allen.

For the reasons explained at pages 89-91 of AEP Ohio's Initial Brief, as well as the rebuttal testimony of AEP Ohio witness Allen, the Commission should reject Staff's proposed exclusion of CWIP from the capacity charge. The Commission's inclusion of environmental CWIP ($33.862 million) in rate base, which is necessary to ensure equal treatment of all customers utilizing the Company's capacity resources, would increase the capacity charge rate by $1.11/MW-Day. (AEP Ohio Ex. 142 at 14.) The inclusion of non-environmental CWIP ($49.422 million) in rate base would increase the capacity charge rate by an additional $1.64/MW-Day. (*Id.* at 15.)

e. Mr. Smith eliminated cash working capital due to the Company's failure to complete a lead-lag study, while conceding that FERC has approved formula-based rates that include cash working capital allowances.

Dr. Pearce's FERC-approved formula rate template includes an allowance for cash working capital as a line item for Return on Production-Related Investment, based on a one-eighth formula method. (AEP Ohio Ex. 102 at Ex. KDP-3, p. 5, and KDP-4, p. 5.) Staff asserts that AEP Ohio's filing "assumed" a cash working capital allowance, "without providing any support for an assumption that AEP Ohio actually has a cash working capital requirement" (Staff Br. at 14), but Dr. Pearce included in his formula rate calculations supporting references to his workpapers. (AEP Ohio Ex. 102 at Ex. KDP-3, p. 5, and KDP-4, p. 5.) And Staff's primary reason for proposing to exclude cash working capital is the lack of a lead-lag study from AEP Ohio. (Staff Br. at 13-15.) As AEP Ohio explained in its Initial Brief, the requirement for a lead-lag study is contained in Standard Filing Requirements for specific statutory proceedings not applicable here. (AEP Ohio Br. at 92.) Moreover, as Mr. Smith conceded at hearing, FERC has previously approved the same one-eighth formula for cash working capital proffered here by AEP Ohio. (*Id.* at 91, quoting Tr. IX at 1979) ("FERC will sometimes approve 1/8 cash working capital.") For the reasons set forth in pages 91-93 of AEP Ohio's Initial Brief, which are incorporated herein, the Commission should reject Mr. Smith's proposed exclusion of cash working capital from the capacity rate. There has been no showing here to justify a zero allowance for cash working capital, because there has been no credible evidence proffered by Staff or Intervenors to suggest that AEP Ohio's investors need not provide any capital to fund ongoing operations of the companies. And the Ohio Supreme Court has previously agreed that the Commission may recognize the one-eighth formula approach in the absence of an "expensive" lead-lag study, saying:

> The theory behind a working capital allowance is the recognition that a utility company must have additional investments in inventories of materials and supplies, and a certain amount of cash in order to sufficiently operate as a business. The allowance is computed as a fraction of the utility's operation and maintenance expense less certain deductions. The fraction is determined by a formula which assumes that charges will be paid within forty-five days after the service is rendered. *The commission has determined the fraction for electric and gas companies to be 1/8*.
> …
> It is conceded by the parties hereto that a lead-lag study would produce the most accurate estimate of a utility's requirement for working capital. *However, lead-lag studies are expensive to conduct. The commission has therefore selected a formula approach which it believes to be a reliable approximation of a utility's working capital requirements. We have also recognized and approved the formula approach as a reliable instrument used by the Commission*.

City of Columbus v. Pub. Util. Comm., 10 Ohio St.3d 23, 24 (1984) (emphasis added). Thus, AEP Ohio's FERC-approved one-eighth formula, though described as unreliable by Staff witness Smith (Staff Ex. 103 at 19), has already been described as a "reliable instrument" by both the Commission and the Ohio Supreme Court. As such, Mr. Smith's proposed elimination of cash working capital should be rejected.

4. The Commission should increase Smith's merged capacity rate for the foregoing reasons.

For the reasons described above and at pages 77-94 of AEP Ohio's Initial Brief, as well as the rebuttal testimony of AEP Ohio witnesses Allen and Nelson, the Commission should adjust Mr. Smith's proposed rate to address the "trapped costs" that both he and Staff witness Harter excluded from their calculations, and reject some of the specific adjustments proposed by Mr. Smith. If the Commission decides to include:

(1) environmental CWIP;

(2) non-environmental CWIP;

(3) prepaid pension asset;

(4) severance expense; and

(5) an ROE of 11.15%,

then the cumulative impact of these changes on the merged capacity rate would be an increase from Smith's proposed capacity rate ($305.48/MW-Day) to a capacity rate of $325.59/MW-Day. (AEP Ohio Ex. 142 at 18.) If the Commission takes that $325.59/MW-Day capacity rate and subtracts an energy credit of $47.16/MW-Day and ancillary service revenues of $6.66/MW-Day, then adds the trapped costs of $20.11/MW-Day as described by Company witness Nelson, then this rate would be $291.58/MW-Day.

5. Dr. Lesser's proposed adjusted fixed production costs inconsistently include capacity equalization revenues as an offset while excluding the costs of the very generation plant that produced those payments.

In its Initial Brief, AEP Ohio demonstrated that Company witness Pearce's formula rate properly includes a calculation of annual production costs that is "reduced by the amount of revenues that are collected from other wholesale entities related to capacity transactions." (*See* AEP Ohio Br. at 95-96, *quoting* AEP Ohio Ex. 102 at 10.) As a result of this calculation, CRES providers receive the benefit of these transactions without paying for any capacity cost that is associated with transactions to other wholesale entities, including affiliates and PJM RPM market participants. (*Id.*) AEP Ohio further demonstrated that FES witness Lesser's proposal to adjust the annual production costs included in the formula rate was inconsistent, inaccurate, and not supported by facts. (*See* AEP Ohio Br. at 95-96.) Notably, Staff agrees with AEP Ohio that the Company's treatment of these costs and capacity equalization revenues is appropriate. (*See* Staff Br. at 44-45.) Accordingly, for the reasons set forth in AEP Ohio's Initial Brief at 95-96 and those in Staff's brief at 44-45, the Commission should reject Dr. Lesser's inconsistent and inaccurate calculation.

D. Intervenor And Staff Arguments That AEP Ohio's Proposed Cost-Based Rate Of $355.72/MW-Day Is Not Comparable To The Level Of Capacity Costs It Recovers Through Base Generation Rates Are Incorrect.

AEP Ohio demonstrated at hearing and in its Initial Brief that its proposed cost-based capacity charge is comparable in value to the amount that the Company receives from SSO customers for capacity through the base generation rates that it charges them. (*See* AEP Ohio Br. at 96-99; AEP Ohio Ex. 142 at 19-20.) Indeed, AEP Ohio witness Allen, in his rebuttal testimony, even calculated that the Company's proposed capacity charge is nearly equal to the amount for capacity that AEP Ohio collects from non-shopping customers. (*See* AEP Ohio Ex. 142 at 20.) Neither Intervenors nor Staff submitted any evidence to refute this fact.

Despite the Company's demonstration that it collects a nearly identical amount from SSO customers for capacity as the amount it proposes to collect from CRES providers here, IEU nonetheless argues on brief that the Company "has not presented any evidence to demonstrate that its proposed cost-based capacity rate … is comparable to the SSO default generation supply service and price." (IEU Br. at 60.) Notably, IEU fails in this argument to cite to or recognize either Mr. Allen's rebuttal testimony or the cross-examination on that testimony. Simply put, IEU's argument on this point either attempts to mislead the Commission with regard to the record evidence in this case or ignores that such evidence exists. In either event, IEU's argument should be disregarded as the Company *has* demonstrated that it is collecting an amount for capacity from non-shopping customers equivalent to its proposal here. Moreover, as RESA witness Ringenbach agreed, given AEP Ohio's demonstration that it is collecting an equivalent charge from SSO customers, it is appropriate for the Company to charge CRES providers

$355.72/MW-Day. (Tr. IV at 815.)[11] Thus, for this reason and for the additional reasons set forth in its Initial Brief at pages 96-99, AEP Ohio should be permitted to recover its proposed cost-based capacity charge from CRES providers.

IV. OEG WITNESS KOLLEN'S ESM PROPOSAL SHOULD NOT BE ACCEPTED.

OEG, at pp. 7-14, outlines Mr. Kollen's alternative recommendations if the Commission does not set capacity charges at RPM.[12] OEG contends, in the alternative, that: (1) the current RPM price of $145.79/MW-Day is a reasonable initial capacity price for a cost-based mechanism; and (2) the Commission should adopt an Earnings Stabilization Mechanism (ESM) to safeguard against over- or under-compensating AEP Ohio. For the reasons set forth at pages 99-103 of AEP Ohio's Initial Brief, the Commission should reject OEG's proposals.

Under OEG's proposal, the capacity price would be $145.79/MW-Day, and AEP Ohio would be subject to an ESM. Specifically, Mr. Kollen recommends that the Commission

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[11] Moreover, it is AEP Ohio's understanding that in other service territories, SSO rates reflect RPM. Thus, CRES providers operating in those service territories and paying RPM-based rates for capacity do so on a level playing field. For this reason too, AEP Ohio should be permitted to charge CRES providers in its service territory a rate equivalent to the demonstrated charge that is reflected in its SSO rates.

[12] OEG's primary recommendation is that capacity should be priced at the prevailing RPM level ($20.01/MW-Day for 2012, $33.71/MW-Day for 2013/2014, and $153.89/MW-Day for 2014/2015). (AEP Ohio Br. at 5-6; OEG Ex. 102 at 9.) OEG witness Kollen does not address in any extensive manner why his primary recommendation of capacity pricing at the prevailing RPM price should be used. Rather, he makes that recommendation simply "as a foundational assumption." (Tr. VI at 1241-1242.) In addition, he admits that his primary recommendation of using prevailing RPM prices does not address the Commission's goal of providing adequate compensation to AEP Ohio (*Id.* at 1276-1277.) He further agrees that if the Commission adopts RPM pricing, then the expected return for AEP Ohio, all else equal, would be dramatically reduced from the 11% ROE level (*id.* at 1261-1262), which AEP Ohio witness Allen has confirmed. (AEP Ohio Ex. 102 at Ex. WAA-2.) OEG also asserts that the Commission could adopt a three-year average of the RPM capacity prices for the next three PJM planning years, which it contends would be $69.20/MW-day. (AEP Ohio Br. at 6.) This is the first time that OEG has raised this concept. It is completely without any evidentiary support and should be rejected.

establish an earnings “deadband” with a lower threshold of a 7% return on equity (ROE) and an 11.0% ROE as the upper threshold. (AEP Ohio Br. at 11; OEG Ex. 102 at 18.) According to Mr. Kollen’s proposal, if AEP Ohio’s earnings, measured by ROE, fall below the lower threshold of 7%, then the Company would be allowed to increase its rates through a non-bypassable ESM charge sufficient to increase its earnings to the 7% level. (*Id.*) If earnings exceed the upper threshold of 11%, then AEP Ohio would return the excess earnings to customers through a non-bypassable ESM credit. (*Id.*) If AEP Ohio’s earnings are within the earnings “deadband,” there would be no rate changes other than those that operate to recover items such as the fuel adjustment clause. However, the Commission “would have the discretion to make modifications as circumstances warrant.” (*Id.*) Mr. Kollen believes that the computation of the earned ROE for his earnings test would be performed in a manner consistent with how it would be done for the SEET, with at least one significant exception. Unlike the SEET, from which the Commission excludes OSS margins, Mr. Kollen would include OSS margins in order to increase earnings and, thus, the earned ROE. (AEP Ohio Br. at 13; Tr. VI at 1290.)

In essence, Mr. Kollen is recommending that AEP Ohio should be subject to a second earnings test, in addition to the “significantly excessive earnings test” (SEET) of §4928.143(F), Ohio Rev. Code. AEP Ohio is subject to the statutory SEET during the current ESP, and it will continue to be subject to it during the next ESP, when Mr. Kollen would apply his ESM earnings test to the Company. Moreover, due to the earnings parameters that Mr. Kollen has proposed for his ESM (in particular the upper threshold of 11%, which is substantially lower than any SEET threshold previously applied to AEP Ohio), the consequence of the proposal would be to render the existing statutory SEET inapplicable and obsolete.

The first problem with Mr. Kollen's ESM/earnings test is that there is no basis under Ohio law for it. The Commission has no statutory authority to impose a second, more stringent, excessive earnings test on AEP Ohio. In short, the 11% upper threshold for determining excessive earnings would be unlawful.

A second fundamental error is that Mr. Kollen's proposal would not permit AEP Ohio to exercise its right, under Schedule 8.1, Section D.8 of the RAA, to establish a price for capacity supplied to CRES providers based on AEP Ohio's cost. Neither Mr. Kollen's primary recommendation to use the prevailing RPM prices nor his alternative recommendation of a price capped at $145.79/MW-Day (coupled with his ESM/earnings test) is based upon AEP Ohio's costs of providing capacity.

Third, Mr. Kollen's ESM/earnings test would not provide any material protection to AEP Ohio from under-compensation of its costs incurred to furnish capacity to CRES providers. On the high end, even Mr. Kollen agrees that the 11% ROE is not indicative of a return that AEP Ohio could expect to earn under either his primary or alternative capacity pricing recommendations. (Tr. VI at 1266.) In short, the 11% return, which Mr. Kollen says is needed on the high side in order to provide symmetry for the under-earnings protection that his recommendation would provide at the 7% low end, is illusory. The protection against under earnings that Mr. Kollen claims he provides to AEP Ohio with his 7% ROE at the low end is also an illusion. Mr. Kollen volunteered that the 7% level is effectively a 5% ROE for the generation function. He also freely conceded that such a low level of earnings is either confiscatory or bordering on confiscatory. (*Id.* at 1271-1272.) Providing the Company with some protection against confiscation is not a measure of reasonableness. It is simply a recognition that, at some point, the regulatory treatment is so egregious that the Company's constitutional rights are being trampled.

In any event, Mr. Kollen's ESM would be complex and difficult to administer, and it would be certain to result in protracted litigation on an annual basis. Even he agrees that if the Company earned less than the low-end ROE of this ESM, and it came to the Commission for a rate increase to make up the shortfall, then intervenors would likely challenge the Company's proposal for additional compensation. (Tr. VI at 1281-1282.) His proposal would also create substantial uncertainty for customers (who would be subject to the risk of future rate increases in the event of under-earnings) and for AEP Ohio (which would be subject to additional risk of over-earnings determinations and, thus, future clawbacks of its prior period earnings).

In short, Mr. Kollen's very low 7% ESM under-earnings threshold, combined with the virtual certainty (based on AEP Ohio witness Allen's testimony regarding the earnings impacts of RPM pricing) that RPM capacity pricing will result in earned ROEs at or below that 7% level, renders OEG's proposal a recipe for financially harming AEP Ohio.

V. THE COMPANY'S PROPOSED COST-BASED CAPACITY CHARGE DOES NOT CONSTITUTE AN UNTIMELY REQUEST FOR RECOVERY OF STRANDED GENERATION INVESTMENT UNDER S.B. 3 AND IS NOT BARRED BY THE STIPULATION ADOPTED IN CASE NOS. 99-1729-EL-ETP, *ET AL.*

The Intervenors continue to advance the same two-step stranded cost argument – first characterizing a cost-based capacity charge as being a recovery of stranded generation investment, and second arguing that it is too late to recover stranded investment.[13] Kroger (at 4-

[13] Notably, the Commission has considered and rejected these same arguments at least once already in this proceeding. Case No. 10-2929-EL-UNC, Opinion and Order at 55 (Dec. 14, 2011) (stating, in its decision initially approving the ESP 2 Stipulation, "[w]e reject the Non-Signatory Parties' claims that SB 3 or the ETP cases foreclosed or conflicts with AEP-Ohio's ability to pursue cost-based capacity rates, at this time").

6) argues that CSP/OP withdrew their claims for recovery of stranded costs in the ETPs and, thus, AEP Ohio is barred by both the ETP settlements and SB 3 from seeking generation transition charges via a cost-based capacity price. IGS (at 10-11) similarly claims that AEP Ohio's proposed capacity charge would "require the Commission to ignore the laws that ended Ohio's transition period" and the statutory requirements set forth in R.C.4928.38-.40. IEU (at 47-50) makes the same argument but also cites AEP Ohio's application in its corporate separation case in an effort to distort the Company's waiver request. IGS (at 4-5) mischaracterizes AEP Ohio's wholesale cost-based capacity charge as an untimely request for generation transition charges. Not to be outdone, FES (at 34-41) makes the same argument but adds that because AEP Ohio previously agreed to waive recovery of stranded costs, it allegedly is barred from obtaining a cost-based capacity charge. Similarly, OMA/OHA (at 11-12) contend that AEP Ohio declined to recover transition costs in its ETP settlements, and thus it is barred from recovering stranded investment in the form of cost-based capacity charges.

For the reasons detailed at pages 103 to 112 in AEP Ohio's Initial Brief, Intervenors' stranded cost arguments are misguided and without merit. Specifically, establishing a wholesale capacity pricing mechanism based on AEP Ohio's embedded capacity costs does not involve R.C. 4928.40 retail generation transition charges. The Intervenors' arguments disregard the important differences surrounding each. Instead, the Intervenors ask the Commission to ignore these differences, as well as the relevant regulatory history and stark changes in the regulatory regimes. The Commission cannot turn its head to these flaws in the Intervenors' arguments. The Company's testimony in support of the cost-based capacity charge demonstrates that the capacity charge is reasonable, and it should be adopted by the Commission.

IEU also raises a new issue on brief in this regard by claiming (at 50) that an internal AEP Ohio accounting memorandum that addressed the narrow issue of asset impairment (reflected in IEU Ex. 124) confirms that AEP Ohio does not have any stranded cost. Even AEP Ohio witness Graves, who had no involvement or responsibilities for AEP Ohio accounting or impairment analysis, readily indicated that such an analysis would consider all revenue streams and look at a long-term evaluation, not a short-term (three-year) view. (Tr. V at 959-960; *see also Modified ESP* Tr. II at 804-805 (AEP Ohio witness Mitchell testifying that an impairment analysis is a long-term analysis typically looking at the lifespan of a generating asset).) Further, it is evident from the face of IEU Ex. 124 that the impairment analysis of the generation fleet was done on the basis of the Pool (a total AEP East view), versus a narrow view of RPM pricing for shopping load in Ohio. Most importantly, in making this argument, IEU does not seem to understand that proving there are no stranded costs (a proposition with which AEP Ohio agrees) also conclusively undercuts IEU's theory that AEP Ohio is seeking recovery of stranded costs. In any case, IEU is wrong in asserting that the impairment memo has any relevance to this case.

VI. IEU'S INVOCATION OF THE VALENTINE ACT AND REQUEST FOR LITIGATION COSTS ARE RED HERRINGS WITHOUT BASIS IN LAW AND SHOULD BE DISREGARDED.

IEU, on pages 67 and 69-70 of its initial brief, makes two completely baseless and inappropriate requests of the Commission. First, IEU asks the Commission to invoke Ohio's Valentine Act in R.C. Chapter 1331 "to reject AEP-Ohio's anticompetitive scheme to preclude free and unrestricted competition among purchasers or consumers in the sale of competitive generation service." (IEU Br. at 67.) IEU even "urges the Commission to seek the advice of counsel" before the Commission "steps outside the law and the discipline of the public interest and again assists AEP Ohio in [its] campaign to preclude free and unrestricted competition…[.]"

(*Id.* at n. 201.) But it is IEU that "steps outside the law" in invoking the Valentine Act. The General Assembly has expressly endowed Ohio's *common pleas courts* with jurisdiction over Valentine Act claims. R.C. 1331.11 ("Courts of common pleas are invested with jurisdiction to restrain and enjoin violators of sections 1331.01 to 1331.14 of the Revised Code.") The Power Siting Board has recently rejected an objection to a Stipulation that had been lodged pursuant to the Valentine Act, acknowledging the common pleas courts' jurisdiction over such matters and noting "[n]or has the General Assembly vested the Board with the task of regulating competition among power plant developers." *In the Matter of the Application of Black Fork Wind Energy, L.L.C. for a Certificate to Site a Wind-Powered Electric Generating Facility in Crawford and Richland Counties, Ohio*, Ohio Power Siting Board No. 10-2865-EL-BGN, Entry on Rehearing (March 26, 2012), at ¶¶ 93-94. There is no small irony in IEU devoting the first half of its initial brief to challenging the Commission's jurisdiction here, only to finish its Brief by seeking affirmative relief under a statute that the Commission patently lacks jurisdiction to enforce.

IEU also asks the Commission to make a "cash payment" of litigation costs to address the "stakeholder resource drain caused by AEP-Ohio's many efforts to hide the real effects of its proposals, bypass Ohio law and common sense and otherwise work to offend the public interest." (IEU Br. at 69-70.) Putting aside the obvious hyperbole in IEU's request, no award of costs is justified here. IEU cites no statute or rule in support of its request. Although Ohio Admin. Code 4901:1-19-15 and R.C. 4903.24 permit the Commission to render discretionary awards of fees and costs, that is when the Commission finds "after investigating that any rate, joint rate, fare, *** or classification of service is unjust, unreasonable, insufficient, unjustly discriminatory, unjustly preferential, or in violation of law…[.]" R.C. 4903.24. Here, the Commission commenced this investigation to establish a state compensation mechanism, not to penalize AEP

Ohio for any existing unjust, unreasonable, or discriminatory capacity rate. And the Ohio Supreme Court has agreed with the Commission's decision *not* to assess costs and expenses where, as here, the party against whom the fees and costs are sought presented "substantial" testimony in good faith. *Cleveland Elec. Illuminating Co. v. Pub. Util. Comm.*, 76 Ohio St.3d 163, 167 (1996). Given that IEU's own litigation tactics, including both of the arguments addressed in this section, contributed to the "resource drain" of which it now complains, IEU's request for a "cash payment" of litigation costs should be denied.

VII. CONCLUSION

Based on the foregoing arguments, the arguments set forth in AEP Ohio's Initial Brief, and the manifest weight of the evidentiary record, the Commission should approve AEP Ohio's proposed capacity charge.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a copy of Ohio Power Company's Reply Post-Hearing Brief was served by electronic mail upon counsel for all other parties of record in this case on this 30th day of May, 2012.

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