BEFORE THE
PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application of	)	
The Ohio Power Company to Establish	)	
A Competitive Bidding Process for	)	**Case No. 12-3254-EL-UNC**
Procurement of Energy to Support	)	
Its Standard Service Offer	)	

DIRECT TESTIMONY

OF

JONATHAN A. LESSER

ON BEHALF OF

CONSTELLATION NEW ENERGY, INC. AND EXELON GENERATION COMPANY, LLC

June 14, 2013

I. INTRODUCTION, PURPOSE, AND SUMMARY OF CONCLUSIONS

Q1. PLEASE STATE YOUR NAME, TITLE, AND BUSINESS ADDRESS.

A1. My name is Jonathan A. Lesser. I am the President of Continental Economics, Inc., an economic consulting firm that provides litigation, valuation, and strategic services to law firms, industry, and government agencies. My business address is 6 Real Place, Sandia Park, NM 87047.

Q2. PLEASE DESCRIBE YOUR PROFESSIONAL QUALIFICATIONS, EMPLOYMENT EXPERIENCE, AND EDUCATIONAL BACKGROUND.

A2. I am an economist with substantial experience in market analysis in the energy industry. I have almost 30 years of experience in the energy industry working with utilities, consumer groups, competitive power producers and marketers, and government regulators. I have provided expert testimony before numerous state utility commissions, as well as before the Federal Energy Regulatory Commission ("FERC"), Congress, state legislative committees, and international venues.

Before founding Continental Economics, I was a Partner in the Energy Practice with the consulting firm Bates White, LLC. Prior to that, I was the Director of Regulated Planning for the Vermont Department of Public Service. Previously, I was employed as a Senior Managing Economist at Navigant Consulting. Prior to that, I was the Manager, Economic Analysis, for Green Mountain Power Corporation. I also spent seven years as an Energy Policy Specialist with the Washington State Energy Office, and I worked for Idaho Power Corporation and the Pacific Northwest Utilities Conference Committee (an electric industry trade group), where I specialized in electric load and price forecasting.

I hold MA and PhD degrees in economics from the University of Washington and a BS, with honors, in mathematics and economics from the University of New Mexico. My doctoral fields of specialization were applied microeconomics, econometrics and statistics, and industrial organization and antitrust. I am the coauthor of three textbooks: *Environmental Economics and Policy* (1997), *Fundamentals of Energy Regulation* (2007), and *Principles of Utility Corporate Finance* (2011).

Q3. ARE YOU A MEMBER OF ANY PROFESSIONAL ORGANIZATIONS?

A3. Yes. I am a member of the International Association for Energy Economics, the Energy Bar Association, and the Society for Benefit-Cost Analysis. I am currently serving a three year position as one of the "Deans" for the Energy Bar Association's professional training program, which focuses on regulatory fundamentals.

Q4. ON WHOSE BEHALF ARE YOU TESTIFYING?

A4. I am testifying on behalf of Constellation New Energy, Inc. and Exelon Generation Company LLC (collectively "Exelon"). Constellation NewEnergy, Inc. ("CNE") provides electricity and energy-related services to retail customers in Ohio as well as in 15 other states, the District of Columbia, and two Canadian provinces. CNE is a competitive retail electric service ("CRES") provider and Exelon Generation Company, LLC owns or controls approximately 35,000 MW of generation, including nuclear, fossil, hydroelectric, solar, landfill gas, and wind generation assets.

Q5. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE PUBLIC UTILITIES COMMISSION OF OHIO ("PUCO" OR "THE COMMISSION")?

A5. Yes. I have testified in numerous proceedings before the Commission, most recently on behalf of First Energy Solutions in Case No. 12-2400-EL-UNC.

Q6. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A6. The purpose of my testimony is to address a variety of aspects related to AEP Ohio's proposed competitive bid process ("CBP"). Specifically, I focus on the importance of a robust and fully competitive CBP to ensure a smooth and efficient transition to full market competition and the 100% auction for AEP's standard service offer ("SSO") load. I conclude the following:

1) The Commission should not attempt to guarantee any specific outcomes from the CBP through imposition of a reserve price cap. Instead, the Commission should focus on ensuring a fully competitive process with maximum auction participation in order to achieve 100% SSO load competition beginning January 1, 2015.

2) The Commission should reject the proposals by the Industrial Energy Users-Ohio ("IEU") and the Ohio Energy Group ("OEG") to set a maximum initial auction offer price at the prevailing Fuel Adjustment Clause ("FAC") rates. Such maximum starting prices, which are called "reserve price caps," will restrict participation in the CBP auctions and limit the development of robust retail competition, which is one of the Commission's fundamental policy goals.

3) The Commission should not have the option of rejecting the results of the SSO auctions, as long as the Commission and independent auction manager determine the auction process to have been fully competitive. Allowing the Commission the option of rejecting auction results *ex post facto* will increase bidder uncertainty, reduce bidder participation, and likely lead to higher final auction clearing prices.

4) The Commission should reaffirm its previous rejection of AEP Ohio's proposal to freeze its Base Generation Rate throughout the entire term of the ESP.[1]

5) The Commission can address IEU/OEG's concerns about above-variable FAC auction results through a crediting mechanism that will reduce the regulatory asset the Commission previously authorized for AEP Ohio to collect embedded capacity costs in Case No. 10-2929-EL-UNC.[2] Unlike the IEU/OEG reserve price cap proposal, this crediting mechanism will not adversely affect the competitiveness or results of the SSO auction results whatsoever, while still recognizing that SSO customers who continue to pay for AEP Ohio's legacy generating asset capacity should be able to benefit from that capacity's relatively low variable operating costs.

6) The Commission should reject AEP Ohio's proposal to charge SSO customers for capacity costs "based on December 2014 cost levels,"[3] as the Entry on Rehearing explicitly required AEP Ohio to charge SSO

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[1] *In the Matter of the Application of Columbus Southern Power Company and Ohio Power Company for Authority to Establish a Standard Service Offer Pursuant to Section 4928.143, Revised Code, in the Form of an Electric Security Plan*, Case No. 11-346-EL-SSO, et al., ("ESP II"), Entry on Rehearing, January 30,2013 ("Entry on Rehearing"), p. 36.

[2] *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, Order, July 2, 2012 ("Capacity Order")

[3] *In the Matter of the Application of The Ohio Power Company to Establish A Competitive Bidding Process for Procurement of Energy to Support Its Standard Service Offer*, Case No. 12-3254-EL-UNC, Supplement to Application, February 11, 2013 ("Application Supplement"), p. 5.

customers $188.88/MW-Day for capacity during the January 1, 2015 through May 31, 2015 period.[4] Moreover, as of January 1, 2015, with a 100% SSO auction, there should be no FAC rider whatsoever.

II. SSO AUCTIONS AND THE TRANSITION TO FULL RETAIL COMPETITION

Q7. WHAT IS THE PURPOSE OF IMPLEMENTING A CBP FOR SSO LOAD?

A7. The purpose of the CBP process is to allow all AEP Ohio customers, not just those who purchase energy from CRES providers, to benefit from retail electric competition. By moving rapidly to auctioning off the right to provide 100% of SSO load, SSO customers will be able to enjoy the benefits that competitive markets provide, even if they are unable or unwilling to take service from CRES providers. Moreover, the CBP process will provide AEP Ohio with a market-based incentive to reduce its costs and operate more efficiently, especially after it no longer is able to recover above-market capacity costs and is no longer guaranteed additional revenues through the nonbypassable Retail Stability Rider ("RSR").

Q8. ARE THERE ANY KEY ATTRIBUTES OF SUCCCESSFUL SSO AUCTIONS?

A8. Yes. Regardless of the auction method (i.e. English, Dutch, second-price, etc.), the key attribute of any successful SSO auction is one that attracts numerous bidders and is fully competitive. The descending-clock or "Dutch" auction

4 Entry on Rehearing, p. 37.

method, for example, is in use for other SSO auctions for Ohio utilities and in several other states because it is recognized as providing excellent price discovery.[5] The auction manager will want to ensure there is no collusion among bidders and that certain bidders do not have informational advantages that can be used to skew the auction results. The Commission itself has determined that AEP Ohio should not be able to participate in the SSO auctions until after it has completed corporate separation, which is scheduled to be finalized by December 31, 2014.

Q9. WHY IS HAVING AS ROBUST A CBP AS POSSIBLE IMPORTANT DURING THE TRANSITION PERIOD TO FULL RETAIL COMPETITION?

A9. The transition period expires on May 31, 2015, less than two years from now. During this period, it is critical to demonstrate to potential SSO bidders that the Commission is fully committed to a competitive market. As the Commission stated in its Entry on Rehearing, "The Commission will not interfere with the competitive markets, and accordingly, we believe it is inappropriate to establish a mechanism to reject auction results."[6] The Commission's statement is precisely the type of "regulatory certainty" auction participants require. To encourage the fullest possible participation in the CBP process, potential bidders must have confidence that the "rules won't change" *ex post facto*.

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[5] For a discussion, *see, e.g.*, L. Mauer and L. Barroso, *Electricity Auctions: An Overview of Efficient Practices*, The World Bank, 2011. Available at: http://ideas.repec.org/b/wbk/wbpubs/2346.html

[6] Entry on Rehearing, p. 35.

If potential bidders believe there is regulatory risk and uncertainty arising from subjective and hidden factors, they will factor in those risks in two ways. First, some potential bidders will simply not participate in the auctions, having concluded that the probability of successfully bidding, and presumably profiting from submitting a successful bid, will be lower. Second, bidders who do decide to participate may add an additional risk premium to their bids. In both cases, potential bidders will be adjusting their behavior to reflect lowered expected gains from participation.

Q10. ARE THERE OTHER AUCTION ATTRIBUTES THAT WILL ENHANCE SUCCESS?

A10. Yes. Because there are administrative costs associated with participating in each CBP, e.g., the costs of qualifying as a bidder, analysis to determine bid prices and quantities, etc., the number of auctions should be limited. Again, this really stems from potential bidders' assessments of the relative costs and benefits of participating in the different auctions. The more auctions that are held, the greater the administrative costs of participation and the lower the expected returns for bidders. To compensate, some potential bidders may either forgo participation entirely or increase the prices at which they bid.

Q11. OCC RECOMMENDS SPLITTING THE INITIAL 22-MONTH AUCTION PRODUCT INTO 10-MONTH AND 12-MONTH PRODUCTS, ARGUING THAT SUCH A SPLIT WILL BENEFIT SSO CUSTOMERS.[7] DO YOU AGREE?

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[7] OCC Initial Comments, March 4, 2013, p. 3.

A11. No. In its Initial Comments, OCC attempts to justify splitting the initial 22-month auction into 10-month and subsequent 12-month auctions by stating:

> Reducing the time between procurement and delivery for this 12-month portion should reduce load and price uncertainty, and thus reduce risk premiums assessed by bidders when they bid on this portion as a separate 12-month product. In other words, OCC's proposed approach should save money for consumers. Second, with only ten tranches on offer in the June 2013 auction, bidding may not be robust enough to support competitive pricing for a 22-month product, especially given the delivery risk for the longer-term product noted above. Shortening the term of the product to ten months may increase bidder interest and promote competitive pricing, or at least limit the damage to consumers from inefficient pricing.[8]

OCC's argument, however, fails to consider the cost side of the equation. That is, OCC does not consider the administrative costs of a full second round of bidding, which as I have explained, would likely reduce bidder participation and raise bid prices.

Moreover, if the 22-month product were split as OCC recommends, the consequences of the limited number of tranches available for the 22-month product would be worsened, not improved. The MWh size of the initial 10-tranche auction would be reduced by more than half, while the MWh size of the June 2014 auction would be increased by a much smaller percentage. (The actual MWh auctioned do not change.) Given the relative changes in tranche size, the adverse effects on the initial 10-month auction would likely be worse than the benefits of a greater number of tranches in the June 2014 auction.

[8] *Id.*, p. 4.

Q12. SHOULD THE COMMISSION BE ABLE TO REJECT THE RESULTS OF A CBP IF IT DEEMS THE FINAL PRICE TO BE TOO HIGH?

A12. No. As long as the auction manager independently determines the CBP auction process and results were fully competitive, then there is no basis for allowing the Commission to reject results it deems unsatisfactory. Imposing this sort of *ex post facto* ability to nullify competitive auction results increases the uncertainty and the costs faced by potential bidders. As a consequence, some potential bidders may simply choose not to bid, which reduces competitiveness. Other bidders may increase the prices of their offers to reflect the uncertainty. Ironically, the ultimate impact of such "nullification" options may be higher final auction prices, to the detriment of SSO customers.

III. CAPPING THE AUCTION PRICE WOULD HAVE ADVERSE IMPACTS ON SSO CUSTOMERS

Q13. DO IEU AND OEG RECOMMEND IMPOSING A PRICE CAP ON THE AUCTION RESULTS?

A13. Yes. Both IEU and OEG recommend the Commission impose a reserve price cap on the SSO auction results set at AEP Ohio's current FAC rates. Furthermore, OEC recommends holding separate SSO auctions for Ohio Power and Columbus Southern Power and applying those companies' individual FAC rates as the reserve price caps.

Q14. WHAT IS A RESERVE PRICE?

A14. In the case of a descending clock, or "Dutch" auction, the reserve price represents the maximum starting bid price. In this proceeding, for example, both

IEU and OEG have proposed to limit the maximum starting price for the descending clock format auction to AEP Ohio's expected FAC. As I explain below, establishing this sort of reserve price would be counterproductive and, I believe, ultimately harm the very SSO customers their proposal is intended to benefit.

Q15. WHY DO IEU AND OEG RECOMMEND THE AUCTIONS HAVE A RESERVE PRICE SET TO AEP OHIO'S FAC?

A15. IEU argues that, if the reserve price is not set at the FAC, then the proposed auction could lead to an increase in the SSO rate.[9] The implicit argument made by IEU is that any final auction price that is higher than the FAC is unjust and unreasonable. OEG expresses a concern that the SSO auction could create a situation in which "the same utility provides the same energy to the same customers, but at a higher price."[10]

OEG further argues that, because SSO customers will be required to pay for AEP Ohio's legacy generating asset capacity costs through May 31, 2015, those customers should only pay embedded energy costs, rather than the market price for energy.[11] As OEG states in its comments, "[t]here is a risk that the energy-only auctions could result in unnecessary and avoidable rates increases to non-shopping customers compared to the cost-based energy rates that those customers would otherwise pay through the FAC."[12] OEG considers this the

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[9] IEU Initial Comments, p. 1.

[10] OEG Initial Comments, p. 1.

[11] *Id.*, p. 3

[12] *Id.*

"worst case scenario," in which SSO customers "are required to pay high average embedded capacity costs based upon base load coal generation and high marginal (market) energy rates, *plus* a risk premium and supplier profit margin."[13]

OEG also argues that, if a reserve price set to the FAC deters bidding, "then it simply means that competitors cannot beat the energy rate to which consumers are entitled by virtue of paying a cost-based rate for capacity."[14]

Finally, OEG argues, "The quid pro quo for receiving a cost-based rate for legacy generation from SSO customers is the provision of energy from those coal units at cost."[15] The OEG argument is that if AEP Ohio bids in its own SSO auction and obtains a market price higher than its base generation rate and FAC cost, then SSO customers will be harmed.

Q16. IS IT POSSIBLE THAT WITHOUT A RESERVE PRICE SET TO THE VARIABLE FAC THE AUCTION-CLEARING CBP PRICES COULD BE HIGHER THAN THAT FAC?

A16. Yes. There is no guarantee that the final auction prices will be less than the FAC in the absence of a specific reserve price set at the variable component of the FAC. Of course, the final auction price may be less than the FAC.

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[13] *Id.*, p. 4 (emphasis in original).

[14] *Id.*, p. 6.

[15] *Id.*, p. 5.

Q17. WOULD A FINAL AUCTION PRICE ABOVE THE VARIABLE COMPONENT OF THE FAC IMPLY THE SSO AUCTION WAS NOT COMPETITIVE OR HAD SOMEHOW "FAILED?"

A17. No. From a market perspective, the results of a competitive SSO auction are completely different than AEP Ohio's variable costs. Instead, what OEG/IEU are addressing is an equity issue, that is, the "fairness" of requiring SSO customers (and, indeed CRES providers' customers) to pay for AEP Ohio's above-market legacy capacity costs, but be unable to benefit from the (possibly) below-market variable costs of those legacy generating assets.

Q18. ARE YOU TESTIFYING THAT THE COMMISSION REVISIT ITS DECISIONS REGARDING CAPACITY COST RECOVERY IN THE ENTRY ON REHEARING OR THE CAPACITY PROCEEDING?

A18. No. While I remain convinced that immediately moving to market-based capacity pricing would have improved competition, I take the Commission's decisions as given and nothing in my testimony suggests revisiting them.

Q19. SHOULD THE COMMISSION ADOPT A RESERVE PRICE CAP TO ADDRESS OEG'S ARGUMENTS?

A19. No. While I understand why OEG and IEU wish to impose a reserve price cap at the FAC as an equity issue, doing so would likely impose far more long-run harm on SSO customers than ensuring a rapid transition to auctioning off 100% of the SSO load. Moreover, unless the Commission's decision on capacity pricing and establishment of a regulatory asset to recover above-market capacity costs is overturned by the Ohio Supreme Court, the issue of AEP Ohio's recovering its embedded capacity costs, rather than the market price for capacity, is moot.

Therefore, the OEG/IEU proposal to establish a maximum auction price at the FAC must be evaluated in terms of whether their proposed auction reserve price cap will promote the Commission's goal of establishing fully competitive electric markets. It will not.

Q20. CAN YOU EXPLAIN WHY?

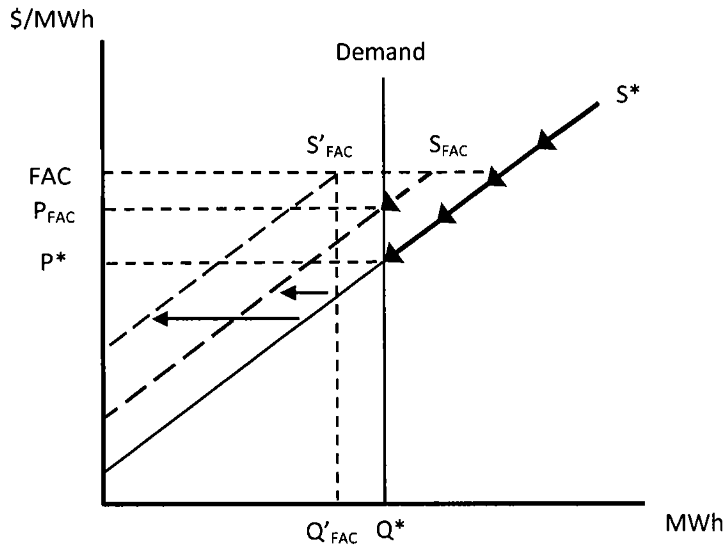
A20. Yes. As the Commission stated in its Entry on Rehearing, "The entire crux of the Opinion and Order was the value in providing customers with the opportunity to take advantage of market-based prices and the importance of establishing a competitive electric marketplace."[16] The OEG/IEU proposal would have the opposite effect, by restricting market competition for SSO customers.

Q21. COULD IMPOSING A RESERVE PRICE CAP AT THE FAC ACTUALLY INCREASE THE CBP AUCTION CLEARING PRICE?

A21. Yes. I demonstrate how that can happen in Figure 1. Although Columbus Southern Power Company and Ohio Power Company have different FACs, for ease of exposition, I assume there is a blended FAC and a single SSO auction for both companies.

[16] Entry on Rehearing, p. 36.

Figure 1: Effect of a Reserve Price Set to the FAC on the CBP Auctions



In the figure, the supply curve without a reserve price at the FAC is shown as S*. As the descending clock auction is run, the quantity offered decreases until the quantity offered matches the fixed demand, Q*. In the figure, the resulting auction clearing price, P*, is assumed to be less than the FAC. The OEG proposal <u>assumes</u> that imposing the reserve price will have no effect on the supply curve, S*. Thus, in Figure 1, OEG's proposal would still lead to the final auction clearing price, P*.

The problem with this is that the imposition of the reserve price cap at FAC can lead to a shift in the supply curve. Not only will potential suppliers offer smaller quantities because of the reserve price cap, other suppliers will drop out altogether. Moreover, to the extent that suppliers who still bid perceive greater regulatory and market risk from participating in the auction, they will increase the risk premiums inherent in their bids. The result will be to shift the supply curve, S* to up and to the left. This is illustrated as the supply curves S_{FAC} and S'_{FAC}.

If the supply curve shifts to S_{FAC}, the resulting market price will be P_{FAC}, which is greater than P*. Thus, the result of imposing the reserve price cap will be a higher final auction price. As a result, SSO customers will suffer an economic loss equal to the amount $Q^* \cdot (P_{FAC} - P^*)$. In the worst case, the reserve price cap will cause enough bidders to drop out or reduce their offer quantities so that the demand Q* cannot be met. This is shown as the supply curve S'_{FAC}. In that case, SSO customers will lose all of the benefits of competition, or the amount $Q^* \cdot (FAC - P^*)$.

Q22. BUT WON'T THE OEG/IEU PROPOSAL BENEFIT CONSUMERS IF THE AUCTION CLEARING PRICE WOULD OTHERWISE BE GREATER THAN FAC?

A22. In the short-run, the OEG/IEU price cap would benefit SSO consumers if the auction clearing price were higher than FAC. However, in the long-run, SSO consumers would suffer greater economic losses because of the chilling effect in the retail market, because the price cap would increase regulatory uncertainty and restrict the number of bidders.

Q23. DID OEG/IEU SUGGEST THAT THE SSO AUCTIONS NOT TAKE PLACE?

A23. No. In their prefiled comments, OEG/IEU did <u>not</u> argue that the Commission should cancel the entire SSO auction process until the advent of full competition (capacity and energy) beginning June 1, 2015. As I understand

OEG's and IEU's comments, they would hold the SSO auctions with the FAC reserve price cap and examine the results: accepting the results if the auction clearing price was less than the FAC and rejecting it if the clearing price were greater than the FAC.

Q24. IF THE COMMISSION ADOPTED THE IEU/OEG PROPOSAL, WOULD THAT HAVE AN ADVERSE IMPACT ON RETAIL MARKET COMPETITION?

A24. Yes. If the Commission, despite stating in the Entry on Rehearing that it would not "interfere with competitive markets,"[17] were to now reverse itself and impose a reserve price cap on the auction, it would send a clear signal to potential bidders that the rules could change in the future. The resulting increase in regulatory uncertainty would likely reduce market participation and raise costs, because the risk of participation will have increased. Moreover, not only would the bidders into the SSO auction be affected, but the retail market served by CRES providers could be adversely affected, because many of those same bidders also will be CRES providers. Increasing regulatory uncertainty reduces the benefits of market competition by increasing supplier costs and risks.

Q25. SHOULD THE COMMISSION REVERSE ITS DECISION IN THE ENTRY ON REHEARING AND ALLOW AEP OHIO TO FREEZE THE BASE GENERATION RATE FOR THE TERM OF THE ESP?

A25. No. As the Commission stated in the Entry on Rehearing,

> AEP Ohio's proposal is completely inconsistent with the Commission's mission and work preclude AEP Ohio customers from realizing any potential savings that may result from its

[17] Entry on Rehearing, p. 35.

> expanded energy auctions ... Further, we find that AEP Ohio's fear of adverse financial impacts in unfounded, as the RSR will in part ensure AEP Ohio has sufficient funds to efficiently maintain its operations.[18]

The Commission is correct. Freezing the Base Generation Rate and blending it with the CBP auction price would prevent AEP SSO customers from benefiting from potential savings, as well as skew the "price to compare" for customers who are considering whether to purchase electricity from CRES providers. Thus, AEP Ohio's recommendation would also have an adverse impact on retail market competition.

Q26. CAN IEU AND OEG MEMBERS PURCHASE ELECTRICITY DIRECTLY FROM CRES PROVIDERS IF THEY BELIEVE THE BLENDED OR FULL AUCTION SSO PRICE IS TOO HIGH?

A26. Of course. This is another flaw in the OEG/IEU reserve price proposal for the SSO auction. IEU and OEG members can negotiate directly with CRES providers. I would expect, for example, that individual members could negotiate lower priced contracts than the prices that would prevail in an unfettered CBP because of higher load factors (i.e., less "peaky" load) and less uncertainty regarding quantities supplied.

In fact, one would expect IEU and OEG members to remain SSO customers only if the resulting blended prices were lower than what they could secure directly in the marketplace. Thus, what OEG is arguing for is the ability to choose the lower of blended SSO or market prices during the ESP. This is a "heads I win, tails you lose" argument. It would also introduce so much

[18] Entry on Rehearing, pp. 36-37.

uncertainty that rational bidders would be unlikely to participate in the CBP auctions, resulting in higher prices and a slower transition to competition. Moreover, it could adversely affect the post-ESP market if CBP bidders assumed the Commission might modify bidding rules after June 1, 2015.

Q27. OEG ARGUES THAT CONCERNS ABOUT A RESERVE PRICE EQUAL TO THE FAC DETERRING BIDDING OR CHILLING THE COMPETITVE MARKET, SUCH AS YOU HAVE DISCUSSED PREVIOUSLY, ARE OVERSTATED. DO YOU AGREE?

A27. No. First, OEG implies there are no downside impacts from imposing a reserve price cap at the FAC, stating that, "From a consumer and economic development point of view, there is certainly nothing wrong with maintaining low prices."[19] Second, OEG argues that concern about the "long-term chilling of the market for auction bids is overstated."[20]

As I showed in Figure 1, OEG's first argument is false, because by driving away bidders and increasing risk premiums, the resulting market prices would be higher than they would otherwise be without the reserve price cap. (This is the increase in price from P* to P_{FAC} shown in the figure and discussed above.) In that case, the reserve price cap would have both short-run and long-run adverse economic impacts. Again, OEG assumes that bidders will not be adversely affected or change their bidding behavior in any way (e.g., by increasing their risk premiums) if a reserve price cap set at the FAC is imposed.

[19] OEG Initial Comments, p. 6.

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

From an economic standpoint, however, OEG's assumption is not credible. Binding price caps always affect firm behavior. Higher prices will have an adverse impact from both a consumer and economic development point of view. Moreover, artificial caps on market prices do not benefit consumers or businesses in the long-run. Instead, artificial caps create additional uncertainty, which reduces investment and raises costs.

Q28. OEG POINTS TO WHAT IT REFERS TO AS THE "FLASH-CUT" ENERGY AND CAPACITY AUCTION AT THE END OF 2011 FOR DUKE ENERGY OHIO'S SSO LOAD AS EVIDENCE THAT A PRICE CAP WILL HAVE NO LONG-TERM CHILLING IMPACT.[21] DO YOU AGREE?

A28. No. OEG's argument suggests that SSO auctions be held, but that the results of those auctions be accepted only if the resulting market prices are below the FAC. OEG has not argued that the Commission modify its Order in the ESP Proceeding to eliminate the SSO auctions until June 1, 2015. Rather, OEG appears to want auctions whose results can be discarded if they are not to OEG's liking. That is not real market competition; it is anti-competitive cherry-picking that will harm SSO customers, especially residential SSO customers whose opportunities for lower-priced power are unlikely to be as prevalent as OEG's members' opportunities.

[21] OEG Initial Comments, p. 7.

Q29. DESPITE YOUR DISAGREEMENT WITH OEG'S RESERVE PRICE CAP PROPOSAL, DO YOU HAVE ANY SUGGESTIONS TO REDUCE THE IMPACT ON SSO CUSTOMERS OF AUCTION PRICES THAT ARE ABOVE THE FAC?

A29. Yes. I propose a crediting mechanism that would address the inherent equity issue raised by OEG/IEU in their recommendation that an auction reserve price cap be imposed equal to the variable component of the FAC.

Q30. CAN YOU EXPLAIN THE EQUITY ARGUMENT?

A30. Yes. Under traditional regulation, the quid pro quo of requiring ratepayers to pay for a utility's generating capacity costs is that they are only required to pay for the variable energy costs of that generation. During the transition period, it is possible that the auction clearing prices will be higher than the FAC, which primarily reflects the cost of fuel of AEP Ohio's legacy generating units.

During the transition period, if the auction price is greater than the variable FAC, then SSO ratepayers will not only pay for the embedded capacity costs of AEP Ohio's legacy generating assets, they will be paying a market price for energy. In 2015, therefore, when AEP Ohio's affiliates will be allowed to participate in the auction, SSO customers could thus pay AEP Ohio's generating affiliate for embedded capacity costs and pay that same affiliate a market price greater than the variable fuel costs of those generation plants. That is the basis for OEG's statement that "the same utility provides the same energy to the same customers, but at a higher price."[22]

[22] OEG Initial Comments, p. 1.

Q31. CAN YOU DESCRIBE YOUR PROPOSED CREDITING MECHANISM?

A31. Yes. In its July 2, 2012 Order in the Capacity Proceeding, the Commission authorized AEP Ohio to create a regulatory asset to recover its above-market capacity costs. As the Commission stated,

> "We also find that, as a means to encourage the further development of retail competition in AEP-Ohio's service territory, the Company should modify its accounting procedures to defer the difference between the adjusted RPM rate currently in effect and AEP-Ohio's incurred capacity costs, to the extent that such costs do not exceed the capacity charge approved today."[23]

Specifically, the Capacity Order authorized AEP Ohio to create a regulatory asset equal to the difference between either embedded capacity costs or $188.88.MW-Day and the prevailing PJM RPM capacity market prices. The regulatory asset subsequently will be recovered as a nonbypassable charge from all AEP Ohio customers.

The crediting mechanism would be applied against that regulatory asset and would work as follows: if the SSO auction clearing price is greater than the variable component of the FAC, then AEP Ohio will reduce the deferral amount in the regulatory asset account by an amount equal to the difference between the auction clearing price and the FAC, times the SSO load served by auction suppliers. In mathematical terms, the credit mechanism can be written as:

$$\text{Credit}_T = (P_{AUCTION} - FAC_V) \cdot LOAD_{SSO} \cdot \text{Blend\%}_T,$$

[23] Capacity Order, p. 33.

where: Credit_T = the credit amount calculated in auction year T that will be subtracted from the regulatory asset, $P_{AUCTION}$ is the auction clearing price, $LOAD_{SSO}$ = the actual SSO load, and Blend% = the auction blending percentage.

For example, suppose the variable component of the FAC is $40/MWh and the auction clearing price is $42/MWh. In 2014, if the total SSO load were 20 million MWh and 60% of that load was served by auction suppliers, then 12 million MWh would be freed up for AEP Ohio to resell. The calculated credit would be $(\$42/\text{MWh} - \$40/\text{MWh}) \cdot (20 \text{ Million MWh}) \cdot (0.60) = \$24 \text{ million}$

A similar approach would be applied in the 2013 auction, where 10% of the SSO load will be served by auction winners and in the 2015 auction, when 100% of the SSO load would be served by auction winners, including, potentially, AEP Ohio itself.

The crediting mechanism recognizes that auctioned SSO load formerly served by AEP Ohio will free up energy that AEP Ohio can sell into the market. Because the FAC represents AEP Ohio's marginal cost of generation, auction prices greater than the FAC will likely mean that PJM energy prices are greater than AEP Ohio's marginal cost of generation, because AEP Ohio's legacy coal plants have high capital costs but low variable costs. Moreover, in the 2015 SSO auction, if AEP Ohio participates and is selected as an auction winner, and if the clearing price is greater than the variable component of the FAC, then AEP Ohio will by definition be paid a market price exceeding its cost-based energy price.

Q32. WILL THIS CREDITING MECHANISM ADVERSELY AFFECT THE SSO AUCTION AND RETAIL COMPETITION?

A32. No. This crediting mechanism will not affect SSO auction bidders because there would be no reserve price cap imposed in the auctions.

Q33. DOES THIS CREDITING MECHANISM UNFAIRLY PENALIZE AEP OHIO?

A33. No. This mechanism simply recognizes that, under the SSO auction, AEP will have an ability to sell additional energy at market rates, rather than cost-based rates. When the Commission adopted the $188.88/MW-Day capacity charge, it recognized the contribution to fixed capacity costs made by variable energy sales. In other words, the amount of profit represented as the difference between the wholesale energy market price and AEP Ohio's variable energy cost were all netted from AEP Ohio's embedded capacity costs. As more SSO load is auctioned, AEP Ohio can sell more energy, and thus potentially increase its wholesale energy-related sales profits.

Q34. WILL AEP OHIO BE UNFAIRLY PENALIZED IF THE AUCTION CLEARING PRICES ARE BELOW THE VARIABLE FAC?

A34. No. In that case, there is no additional crediting, even if AEP Ohio's can still sell more power into the wholesale energy market at a profit. Moreover, if the variable operating costs (primarily fuel) of AEP Ohio's generating units were greater than the market price, AEP Ohio would rationally choose not to operate those units and would, instead, purchase additional, lower-cost energy from the wholesale market.

Q35. WOULD YOUR CREDITING MECHANISM AFFECT AEP OHIO'S ABILITY TO RECOVER ITS PRUDENTLY INCURRED, AUCTION-RELATED COSTS?

A35. No. As long as AEP Ohio demonstrated that these costs: (1) were actually incurred; (2) were directly related to serving SSO customers; and (3) were prudent, just, and reasonable, then AEP Ohio would be allowed to recover them. Thus, to the blended rate described above, AEP Ohio could add a fully bypassable auction cost rider. This rider should not include any known and measurable POLR costs, however, as those should be accounted for separately.

IV. THE COMMISSION SHOULD REJECT AEP OHIO'S PROPOSAL TO CHARGE SSO CUSTOMERS FOR CAPACITY COSTS "BASED ON DECEMBER 2014 COST LEVELS" AND ELIMINATE THE FAC AS OF JANUARY 1, 2015

Q36. HAS AEP OHIO PROPOSED TO RECOVER ITS EMBEDDED CAPACITY COSTS, BASED ON DECEMBER 2014 AMOUNTS, STARTING ON JANUARY 1, 2015?

A36. Yes. In its Application Supplement, AEP Ohio proposes to recover capacity cost based on "December 2014 cost levels."[24]

Q37. SHOULD AEP OHIO BE ALLOWED TO RECOVER ITS EMBEDDED CAPACITY COSTS FROM SSO CUSTOMERS BEGINNING JANUARY 1, 2015?

A37. No. In the Entry on Rehearing, the Commission clearly addressed this issue, stating "In light of the Commission's decisions in the Capacity Case, which determined $188.88/MW-Day would allow AEP Ohio to recover its embedded

[24] February 11 Supplement, p. 5.

capacity costs without overcharging customers, it would be unreasonable for us to permit AEP-Ohio an amount higher than its cost of service."[25]

Beginning January 1, 2015, when 100% of AEP Ohio's SSO load will be auctioned off, the Commission has set AEP Ohio's capacity costs to the $188.88/MW-day. Additionally, full corporate separation will have been accomplished. Therefore, as of January 1, 2015, there should be no FAC whatsoever (whether it remains bundled or gets unbundled as proposed by AEP). With respect to the specific "Non-Energy (Fixed)" component of the FAC included in the unbundling proposal, if allowed past January 1, 2015, AEP would effectively double-recover some of its capacity costs, which is inconsistent with basic cost of service ratemaking. And even AEP admits that the "energy" portion of the FAC should be eliminated by January 1, 2015.

Q38. DOES THIS CONCLUDE YOUR TESTIMONY?

A38. Yes. However, I reserve the right to supplement my testimony as new information subsequently becomes available or in response to positions taken by other parties.

[25] Entry on Rehearing, p. 37.

CERTIFICATE OF SERVICE

I certify that a true and accurate copy of the foregoing document was served by electronic mail this 14th day of June, 2013 upon the persons listed below.

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