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INTRODUCTION

This case involves an action by the Public Utilities Commission of Ohio (Commission) to reach beyond the predetermined audit period into a prior unregulated period, in an effort to apply only a single targeted transaction from that period. There are two distinct periods of time that must be examined when reviewing the Commission's decision below to seize the value of a 2008 Buyout Agreement entered into between Ohio Power Company (dba AEP Ohio) and a coal supplier. The first period was 2006-2008, a time of deregulated fuel rates when the Commission approved bundled rates for AEP Ohio's generation service with no separate fuel adjustment clause to ensure recovery of prudently-incurred fuel costs.¹ During the entire term of the prior rate plan, the Company was at risk for unrecovered fuel costs because the rates in effect reflected a frozen level of fuel costs and any fuel costs above that level would cause a loss. During this first period, coal prices were volatile and reached historically high levels (coal prices are the dominant form of fuel costs) and AEP Ohio was only allowed to collect a fixed level of fuel costs in retail rates. The Company was on its own to manage and absorb such losses during this initial time period.

The second time period was 2009-2011, a time of regulated fuel rates based on a newly-enacted law. The second time period necessitated the unbundling or separation of AEP Ohio's generation rates into a non-fuel generation rate and a fuel adjustment clause baseline. A fuel adjustment clause was established so the Company could concurrently recover its prudently-

¹ A fuel adjustment clause is a distinct rate component for generation service that separates fuel costs (predominantly coal purchase costs) and reconciles rates collected with actual costs prudently incurred. Because fuel costs are a large component of an electric utility's overall cost for providing generation service and are often volatile, it is common under traditional regulation for electric utilities to have a fuel adjustment clause for contemporaneous recovery of all prudently incurred fuel costs. During the period prior to 2009, however, AEP Ohio had a rate plan that did not have a fuel adjustment clause – as part of a carefully balanced rate plan agreed to by the Company.

incurred fuel costs through retail generation rates, eliminating the risk of the Company absorbing the losses of fuel prices that are higher than the level that was reflected in rates. The structure of the system changed from an unregulated system back to a regulated system between the two periods, based on the enactment of a new law affecting rate plans starting in 2009.

The decision below implemented a new law that affected standard service offer generation rate plans beginning in 2009. Yet, the Commission applied the new law by adjusting current² fuel rates to effectively exclude certain fuel costs relating to the prior “unregulated” period and by selectively seizing the value of the 2008 Buyout Agreement as a rate credit to be applied during the “regulated” period. Thus, the Commission engaged in unlawful retroactive ratemaking and inappropriately conflated the two separate time periods after-the-fact, even though each time period was regulated differently, was based on application of different laws; more importantly, the decision below effectively modified previously-approved rates charged during the first period that were the regulatory equivalent of “water over the dam.” At no time were there allegations, let alone determinations by the Commission, that the Company did not prudently incur any of the displaced 2009 fuel costs or that the Company did not properly account for the fuel costs during the two separate periods in question. Rather, the Commission invented an extra-statutory concept not previously disclosed or relied upon to conclude that the “true cost” for fuel in 2009 was something other than what was recorded on the Company’s books – based on transactions that occurred in 2008 when fuel costs were deregulated under the prior legislative and regulatory regime. Unlike all prior fuel cases that are driven by actual costs and proper accounting, the Commission’s new “real economic cost” standard is a subjective and arbitrary concept. AEP Ohio cannot keep its books and records based on an after-the-fact

² AEP Ohio uses the term “current” for purposes of this appeal to refer to 2009, since that is the audit period at issue in the decision below.

subjective view of what is later deemed to be the “true economic cost” and it is purely fictional for the Commission to attempt to impose such a standard.

The Commission’s orders at issue in this appeal are unlawful and unreasonable. First, it is unlawful retroactive ratemaking for the Commission to “clawback” a gain that was properly realized and accounted for in 2008 in order to support a fictional conclusion that the “real” fuel costs in 2009 were lower than reflected on the Company’s books. Alternatively, it is arbitrary, unreasonable and against the manifest weight of the record for the Commission to ignore other costs incurred during 2008 that significantly increased fuel costs during that period and selectively offset 2009 fuel costs with only one 2008 fuel agreement that creates the perception that the Company made money while ignoring other 2008 fuel agreements that would substantially increase fuel costs and correspondingly reduce the Company’s earnings. The Commission cannot lawfully “cherry pick” from the prior period to exclude recovery of costs prudently incurred during the present recovery period. Second, the Commission’s seizure of the book value of the coal reserve asset is unlawful and unreasonable for the additional reason that customers have no valid claim on a real estate asset owned by the Company. Finally, the decision below also unlawfully violated the Commission’s prior adjudicatory decision establishing the fuel adjustment clause for the second period of time, where the Commission had both: (i) established a fuel adjustment clause baseline that would be used going forward to separate the prior bundled rates from the new unbundled rates; and (ii) determined that the fuel adjustment clause would be limited to fuel costs incurred during each annual period in question. Nothing in the prospective creation of the second period fuel adjustment clause allowed the Commission to reach back into the unregulated period and review those prior decisions that occurred in the absence of a fuel clause. The Court should require the Commission to follow the

doctrines of *res judicata* and collateral estoppel with respect to its prior adjudicative decisions. Each of the three above-described reasons provides ample basis for this Court to reverse and remand the Commission's decision below.

STATEMENT OF FACTS AND OF THE CASE

There are three distinct but related sets of factual developments that are pivotal to fully understanding the decision below: (A) the old regulatory regime that was in effect when the 2008 Buyout Agreement was entered into by AEP Ohio under the prior law, (B) the new regulatory regime effective in 2009 when the fuel adjustment clause was implemented under a newly-enacted law, and (C) the facts and record established below as a predicate for the Commission's decision.

A. Enactment of SB 3 and Market-Based Pricing without a fuel adjustment clause through 2008

Am. Sub. S.B. No. 3, effective October 5, 1999 (SB 3), restructured regulation of electric utilities and introduced retail customer choice for electric generation service, largely deregulating generation service in Ohio. Rates for competitive generation service were established based on market-based pricing. Under SB 3, the Company established a rate stabilization plan that was in effect from 2006 through 2008. Under the Company's rate stabilization plan, there was no fuel adjustment clause or comparable mechanism to recover the fluctuating cost of fuel and there was no guarantee that the rate stabilization plan's generation rates would cover the Company's fuel costs during the rate stabilization plan term. (*Rate Stabilization Plan*, Case No. 04-169-EL-UNC, January 26, 2005 Opinion and Order (Appx. at 176.); March 23, 2005 Entry on Rehearing (Appx. at 267.)) As the Commission's own Auditor stated, the rate stabilization plan term was "a period in which fuel cost recovery was not regulated." (Audit Report at 1-6.) (Supp. at 20.) This was the status through the end of 2008.

AEP Ohio was “on its own” with respect to recovery of fuel costs during the rate stabilization plan period of 2006 through 2008. There was a fixed level of fuel costs embedded in rates during that period but the Company had all the risk to the extent costs rose above that threshold. And this was a time of fuel price volatility. Indeed, the Auditor acknowledged that during the rate stabilization plan term, short-term coal prices experienced unprecedented volatility and *tripled* between mid-2007 and mid-2008. (Audit Report at 2-4.) (Supp. at 27.) Without a fuel adjustment clause in effect, AEP shareholders bore the total risk of increased fuel costs. The Auditor verified that during 2007-2008 period, coal prices in the United States reached all-time high prices. (Tr. I at 61.) (Supp. at 100.) As Company witness Rusk testified, during this first period, without a fuel adjustment clause, not only did delivered costs for coal in Ohio increase dramatically, but there was also unprecedented volatility in coal markets. (Co. Ex. 2 at 15.) (Supp. at 83.) High and volatile coal prices created ideal circumstances for having a fuel adjustment clause for a Company, but after AEP Ohio did not have such a mechanism at this time and, while it weathered this storm without one, the Commission now engages in “cherry picking” certain upside results achieved by AEP Ohio under its prior rate plan to use against it in a later unrelated period.

During this extraordinary historical period of coal procurement when fuel costs were not regulated, the Company entered into several transactions to manage coal prices while maintaining a reliable supply. Included among the procurement transactions reviewed by the Auditor are two transactions that are pertinent to the issues being raised on appeal: (1) a January 2008 settlement agreement which terminated the 20-year contract with a coal supplier effective at the end of 2008 (2008 Buyout Agreement), and (2) a February 2008 contract support agreement with a third coal supplier to help maintain the supplier’s solvency through a

production bonus payment and a temporary increase in the per ton price for coal (2008 Production Bonus Agreement). (Audit Report at 2-20 through 2-24.) (Supp. at 43-47.) Neither of these transactions were found to be imprudent in the Audit Report or the Opinion and Order. In fact, the Auditor praised AEP management for its performance in managing this extraordinarily challenging period. (*Id.*)

B. Enactment of SB 221 and the Adoption of a fuel adjustment clause for AEP Ohio as part of the 2009-2011 Electric Security Plan

Am. Sub. S.B. No. 221, effective July 31, 2008 (SB 221), modified the method for setting standard service offer (SSO) rates for electric service and created new requirements for alternative energy, energy efficiency and peak demand reductions. On the effective date of SB 221, the Company filed an Electric Security Plan in Case Nos. 08-917-EL-SSO and 08-918-EL-SSO (“*Electric Security Plan Cases*”). In deciding the *Electric Security Plan Cases*, the Commission changed course from the prior period and adopted a fuel adjustment clause mechanism for AEP Ohio, concluding as follows:

The Commission believes that the *establishment of a [fuel adjustment clause] mechanism as part of an [Electric Security Plan] is authorized pursuant to Section 4928.143(B)(2)(a), Revised Code, to recover prudently incurred costs associated with fuel*, including consumables related to environmental compliance, purchased power costs, emission allowance, and costs associated with carbon-based taxes and other carbon-related regulations. Given that the [fuel adjustment clause] mechanism is authorized pursuant to the [Electric Security Plan] provision of SB 221, *we will limit our authorization, at this time, to the term of the [Electric Security Plan.]*

* * *

Therefore, we find that the [fuel adjustment clause] mechanism with quarterly adjustments *as proposed by the [Company]*, as well as an *annual prudency and accounting review recommended by Staff*, is reasonable and should be approved and implemented as set forth herein.

(*Electric Security Plan Cases*, Opinion and Order at 14-15 (emphasis added).) (Appx. at 112-113.) Hence, the Commission approved the proposed fuel adjustment clause mechanism,

pursuant to the new law that had been enacted for rate plans beginning January 1, 2009 (SB 221), for prospective operation during the term of the Electric Security Plan. Significantly, the scope of the approved fuel adjustment clause was explicitly confined to begin in 2009 and end after 2011, with annual prudence reviews during the term of the fuel adjustment clause. The holding that the adopted fuel adjustment clause mechanism was strictly limited to the Electric Security Plan term was affirmatively reinforced as part of the record below in the entry initiating the RFP for the audit and again in the entry selecting the auditor for this proceeding. (See November 18, 2009 Entry at 1; (“The Commission limited its authorization of the fuel adjustment clause provisions to the term of the Electric Security Plan.”); January 7, 2010 Entry at 1 (same).)

In order to make the transition from the first period where fuel costs were not regulated to the second period discussed, an active fuel adjustment clause, the Commission needed to establish a fuel adjustment clause baseline to separate AEP Ohio’s generation rates into fuel and non-fuel components. The Commission weighed the evidence carefully and found that a proxy is appropriate to establish a baseline, adopting Staff’s method of using actual 2007 fuel costs and adjusting by 3% and 7% for AEP Ohio’s two rate zones. (*Electric Security Plan Cases*, Opinion and Order at 19.) (Appx. at 117.) On rehearing in the *Electric Security Plan Cases*, the parties again advanced their positions and the Commission reiterated that it had fully considered the evidence and would not change its decision.

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

(*Electric Security Plan Cases*, Entry on Rehearing at 6.) (Appx. at 287.)

Thus, the scope of the fuel adjustment clause approved for the second period was part of the Company's *Electric Security Plan Cases* in 2009. The key fuel adjustment clause findings previously adjudicated and decided in those *Electric Security Plan Cases* were that: (1) the fuel adjustment clause mechanism would be limited to the Electric Security Plan period, excluding both the pre-Electric Security Plan period and the post-Electric Security Plan period; (2) annual prudence review of fuel costs would be confined to fuel costs incurred in 2009, 2010 and 2011, respectively; and (3) the fuel adjustment clause baseline was set as a one-time determination to put the pre-Electric Security Plan period fuel costs in the past and transition the Company from a non-fuel adjustment clause period to an active fuel adjustment clause period. In short, establishment of the fuel adjustment clause baseline and other matters involving operation of the fuel adjustment clause mechanism during the Electric Security Plan were hotly contested issues that the Commission fully adjudicated and decided in the *Electric Security Plan Cases*. Notably, in establishing the fuel adjustment clause baseline and strictly confining the scope of the fuel adjustment clause mechanism to the Electric Security Plan term, the Commission was explicitly aware at that time of the volatile coal prices and extraordinary coal procurement activities that occurred in 2008 in reaching its decision regarding the fuel adjustment clause baseline. (*Electric Security Plan Cases*, Entry on Rehearing at 5.) (Appx. at 286)

C. The Commission's review of 2009 fuel costs and seizure of the value of the 2008 Buyout Agreement that occurred prior to the 2009-2011 Electric Security Plan.

The case below involved the Commission's review of the first annual audit of AEP Ohio's new fuel adjustment clause established as a component the 2009-2011 Electric Security Plan. Prior to the approval of its 2009 Electric Security Plan, AEP Ohio's rates, terms and conditions of retail electric generation service were governed by a three-year (2006-2008) rate

stabilization plan that had no mechanism to guarantee that AEP Ohio would recover its actual fuel costs in rates. As a result, AEP Ohio was “on its own” with respect to the recovery of its actual fuel costs during a period of time when coal prices experienced unprecedented volatility. Short-term coal prices tripled between 2007 and 2008. The 2009 Electric Security Plan established the fuel adjustment clause, which was limited to the term of the Electric Security Plan, and which authorized AEP Ohio to recover its prudently-incurred fuel costs as determined through an annual prudency and accounting review. The purpose of the review is to “approve [the] appropriateness of the accounting of the fuel adjustment clause costs and the prudency of the decisions made.” (Audit Report at 1-1.) (Supp. at 15.)

On September 29, 2010, AEP Ohio filed its application for the review of its 2009 fuel costs. Pursuant to a Commission Entry issued January 7, 2010, Energy Ventures Analysis, Inc. (“EVA” or the “Auditor”) was selected to perform AEP Ohio’s fuel adjustment clause audit for 2009. EVA submitted its Audit Report to the Commission on May 14, 2010. The Auditor concluded that AEP Ohio had under-recovered its prudently incurred fuel costs in 2009 by \$297.6 million. (*Id.* at 1-5.) (Supp. at 19.) One of the recommendations made by the Auditor, however, was that the Commission should review whether any of the proceeds from a settlement agreement AEP Ohio entered into with a coal supplier in 2008 should be used as a credit against AEP Ohio’s 2009 under-recovery of fuel costs in 2009. (*Id.* at 1-6) (Supp. at 20.)

In its January 23, 2012 Opinion and Order, the Commission determined (at 12) that all of the unrealized value of that 2008 Buyout Agreement should be credited against AEP Ohio’s 2009 fuel adjustment clause under-recovery. (Appx.at19.). The 2008 Buyout Agreement resulted in total proceeds of \$71.6 million (\$30 million in cash and a coal reserve valued at that time to be \$41.6 million). (AEP Application for Rehearing at 13-14.) (Appx. at 74-75.) AEP

Ohio recorded the 2008 Buyout Agreement as a gain of \$58.3 million in 2008 and a gain of \$13.3 million total in 2009 and 2010. The Company applied the Ohio retail share of the \$13.3 million gain recorded in 2009 and 2010 to reduce fuel costs in 2009 and 2010. (*Id.*) In its January 23, 2012 Opinion and Order, the Commission ordered, among other things, that all the remaining value from the 2008 Buyout Agreement should be credited against the current fuel adjustment clause to the benefit of ratepayers. While Ohio Power argued on numerous grounds no additional portion of the 2008 Buyout Agreement asset value (the cash or the coal reserve) should be credited to Ohio retail customers, it argued in the alternative that, if any such additional credit was ordered, it necessarily had to be limited to that portion of the remaining value allocable to Ohio retail jurisdictional customers. (AEP Ohio App. for Rehearing at 12-14.) (Appx. at 73-75.) The Commission clarified that “the 2009 [fuel adjustment clause] under-recovery need only be credited for the share of the settlement agreement allocable to Ohio’s retail jurisdictional customers.” (April 11, 2012 Entry on Rehearing at ¶18.) (Appx. at 37.)³ Thus, the impact of the Commission’s final order below was to credit the retail allocation of an additional \$58.3 million to the current fuel adjustment clause, which amount reflected the retail jurisdictional portion of the 2008 Buyout Agreement not already credited to ratepayers. The Commission issued its final entry on rehearing to clarify certain matters on July 2, 2012, and this appeal was timely filed on August 30, 2012.

³ The Industrial Energy Users-Ohio (IEU) challenge the retail versus total company allocation of the \$58.3 million value through its cross-appeal filed in this case, which will be the subject of separate merit briefing.

LAW AND ARGUMENT

Proposition of Law No. I:

The Commission's decision to reduce current rates, by seizing the value of the 2008 Buyout Agreement entered into with a coal supplier during a prior period when fuel costs were deregulated, constitutes unlawful retroactive ratemaking.

The undisputable financial impact of the decision below is to retroactively increase 2008 fuel expenses after the period in which rates were approved and charged, by eliminating the gain from a single transaction in 2008 after-the-fact and applying it to reduce recovery under the 2009 fuel adjustment clause. Alternatively, the "clawback" decision is arbitrary, unreasonable and against the manifest weight of the record because it selectively ignored another 2008 fuel agreement that substantially increased fuel costs and reduced earnings. Either way, the decision to seize the value of AEP Ohio's 2008 Buyout Agreement, including the coal reserve asset, was unlawful and unreasonable and should be reversed.

A. The decision to seize the value of the 2008 Buyout Agreement, a contract that was outside of the audit period under review, violates Ohio's prohibition on retroactive application of laws and constitutes unlawful retroactive ratemaking. Ohio Const. Art. II, Section 28; Ohio Rev. Code Ann. 1.48 (2012); *Keco Industries, Inc. v. Cincinnati & Suburban Bell Tel. Co.*, 166 Ohio St. 2d 254, 141 N.E. 2d 465 (1957); *Lucas Cty. Commrs. v. Pub. Util. Comm.*, 80 Ohio St.3d 344, 656 N. E. 2d 501 (1997).

In Ohio, there is a constitutional prohibition against the retroactive application of statutes, Section 28, Article II of the Ohio Constitution, and a statutory presumption in favor of prospective laws, R.C. 1.48. SB 221 did not become effective until July 31, 2008 and provided for new rate plans to be established effective in 2009. Because AEP Ohio's fuel costs under the prior law were not regulated during the 2001 through 2008 period and because the Electric

Security Plan's fuel adjustment clause mechanism under the new law only became effective in 2009, the fuel adjustment clause cannot be applied retroactively to encompass transactions occurring in 2008. The same effect would result through any current prudence review of the 2008 contracts for the purpose of disallowing any portion of the ongoing cost impact of those contracts, which were entered into during a period of fuel deregulation when such contracts were not regulated. In the decision below, the Commission explicitly acknowledged that AEP Ohio's fuel costs "were not regulated during the period when the buyout occurred." (Opinion and Order at 12-13.) (Appx. at 19.) Unfortunately, the Opinion and Order went on to "clawback" the value associated with the 2008 Buyout Agreement.

The approach taken in the Opinion and Order violates the terms of the rate stabilization plan rate plan, which excluded a fuel adjustment clause, as well as the new fuel adjustment clause adopted in the *Electric Security Plan Cases* and amounts to the retroactive application of SB 221 in violation of the Ohio Constitution and Ohio Revised Code. The Commission understood that it could not lower rates for 2008 as part of its 2012 decision below; likewise, the Commission should be prohibited from applying a credit to current rates based on the value of the 2008 Agreement. Yet, the effect of the Opinion and Order is to retroactively increase 2008 fuel costs by confiscating the value of the 2008 Buyout Agreement, including the coal reserve asset, that was already booked in 2008 under proper accounting principles as an offset to fuel costs. In addition to violating the constitutional prohibition on retroactive application of laws, the "clawback" credit of amounts booked in 2008 during the prior rate plan (*i.e.*, the rate stabilization plan period) also violates the longstanding prohibition against retroactive ratemaking established in *Keco Industries, Inc. v. Cincinnati & Suburban Bell Tel. Co.* (1957), 166 Ohio St. 254, 141 N.E. 2d 465 (1957).

The key principles in the *Keco* decision form Ohio's version of the "filed rate doctrine" and establish the following principles of strictly prospective ratemaking:

- Rates set by the Commission are lawful until such time as they are set aside by the Supreme Court and modified on remand by the Commission;
- A utility is entitled to and must collect the rates set by the Commission, unless a stay order is obtained; and
- No action for unjust enrichment lies to recover the rates that were subsequently determined to be unlawful because the comprehensive regulatory scheme in Title 49 abrogates any common law action in this regard.

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

The Supreme Court's decision in *Lucas Cty. Commrs. v. Pub. Util. Comm.*, 80 Ohio St.3d 344, 686 N.E. 2d 501 (1997) is part of the *Keco* progeny, *Ohio Consumers' Counsel v. Pub. Util. Comm.*, 121 Ohio St. 3d 362, 367, 2209 Ohio 604, 904 N.E. 2d 853 (Ohio 2009), and is also instructive. The *Lucas County* decision stands for the proposition that, because the Commission may exercise only that jurisdiction conferred by statute and none of the statutes in Title 49 authorizes the Commission to order refunds based on expired programs, the Commission could not order a refund after a pilot program was terminated. Thus, even where the Commission in retrospect disapproves of a utility decision or activity or cost that has already been incurred and collected by the utility pursuant to rates approved by the Commission, the Commission cannot "clawback" any revenue collected under a prior rate.

In addressing an analogous situation, the United States Court of Appeals for the Eighth Circuit memorably concluded that the applicable law was like a "fence that is hog tight, horse high, and bull strong" preventing the federal agency from exceeding its regulatory jurisdiction. *Iowa Utilities Board v. FCC*, 120 F.3d 753, 800 (Eighth Cir. 1997) (reversed in part and affirmed in part). Likewise, the filed rate doctrine under *Keco* and progeny is a bedrock principle of Ohio

regulatory law that forms an impenetrable barrier preventing the Commission from engaging in retroactive ratemaking.

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

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

(Opinion and Order at 13-15.) (Appx. at 20.) The Commission's efforts to avoid *Keco* and *Lucas County* fail.

Respectfully, the Commission's "real economic cost" basis for reaching back into the prior rate plan, selectively extracting amounts related to the 2008 Buyout Agreement, and offsetting those amounts against AEP Ohio's fuel costs in 2009 (and future periods) does not have a legal or record basis. By offsetting prudently incurred 2009 costs with amounts related to 2008, the financial impact is that the Commission has retroactively increased fuel expense in 2008 without changing the 2008 rates (thereby causing a loss to the Company). Contrary to the fictional view adopted by the Commission in the decision below, the "real economic cost" of the fuel costs incurred in 2009 for Ohio retail jurisdiction fuel adjustment clause customers is

accurately measured by the amounts recorded on AEP Ohio's books of account for 2009. There is no evidence to rebut the presumption that AEP Ohio's fuel costs in 2009 were prudent. Indeed, the testimony and evidence, as well as the Commission's findings, confirm that the costs AEP Ohio incurred for fuel, and properly recorded on its books of account, for 2009 were prudently incurred.

Moreover, there is no basis for the Commission's statement that, as a result of the 2008 Buyout Agreement, AEP Ohio paid significantly more for coal beginning in 2009, the start of the electric security plan period, than would have been paid had the 2008 Buyout Agreement not been entered into. The evidence confirms that the probable result, absent the 2008 Buyout Agreement, was that the supplier for the underlying coal contract would have defaulted and AEP Ohio would have had to procure replacement coal at higher market prices. (Audit Report at 2-23 – 2-24.) (Supp. at 46-47.) In addition, the Commission's rationale ignores the fact that AEP Ohio incurred substantial additional costs in 2008 to provide support to another supplier which enabled that supplier to avoid defaulting on its coal supply arrangement, which allowed AEP Ohio to continue to obtain coal supplies in 2009 and beyond at costs below what would have been incurred if that supplier had defaulted. AEP Ohio did not seek to recoup those supplier support costs in 2009 (or future periods) through the fuel adjustment clause since these costs were incurred prior to the period when the fuel adjustment clause was effective.

Also regarding application of *Keco* and the Commission's defense, it is inaccurate to claim that the Commission is not modifying a rate previously approved. As explained above, the financial impact of the Commission's decision is to modify the prior rate plan that was approved by the Commission, by reaching back into 2008 (when fuel costs were not regulated) and retroactively eliminating the fuel cost offset properly booked in 2008. The fact that the

“remedy” is a prospective adjustment to rates is unavailing as that is always true in cases involving unlawful retroactive ratemaking.

The effort to distinguish *Lucas County* is similarly flawed. The practical effect of the Commission's decision is to retroactively reduce the rates for generation service charged in 2008 by the amount of the offset made to costs in 2009. Because the 2008 Buyout Agreement was properly booked in 2008 and the Commission is now unlawfully confiscating that asset on a retroactive basis – while 2008 fuel costs have increased without any rate change or compensation to the Company – the decision below unlawfully implements an after-the-fact change to the rates approved as part of the rate stabilization plan.

Finally in this regard, the Opinion and Order's statement (at 13) that it is merely engaging in fuel cost reconciliation and accounting, as was contemplated in the *Electric Security Plan I* proceeding, is disingenuous at best. The Commission has not reconciled rates to prudently-incurred expenses as is normally done. Rather, it has effectively increased the 2008 fuel expenses after-the-fact by retroactively modifying the Company's proper accounting without changing the rates actually charged and collected during that period. The Commission's adjustment departs from the approved and stated purpose of the fuel adjustment clause, which was to reconcile fuel adjustment clause rates charged in 2009 to actual fuel costs incurred in 2009. The result is unlawful retroactive ratemaking. The plain and undisputable impact of the decision below is to retroactively adjust (through current rates) the rates from 2008 that were previously approved and charged to customers. Because this violates Ohio's longstanding prohibition against retroactive ratemaking, this aspect of the decision should be reversed.

B. It is arbitrary, unreasonable and against the manifest weight of the record for the Commission to reach back and selectively offset recovery of fuel costs in 2009 only for benefits of the 2008 Buyout Agreement while ignoring the 2008 Production Bonus Agreement that substantially increased fuel costs and reduced earnings.

If the Court somehow concludes that the Commission's seizure of the 2008 Buyout Agreement value does not constitute unlawful retroactive ratemaking, it should alternatively find that the decision is arbitrary and unsupported by the manifest weight of the record. It is clear that the Commission's order in this case is a one-way, results-oriented approach designed to reduce rates. The Commission ordered AEP Ohio to credit its customers with the retail share of an additional \$58 million through a fictional, after-the-fact realignment of the benefits associated with the 2008 Buyout Agreement, but it completely ignored the fact that AEP Ohio incurred a \$28.6 million loss as a result of a different 2008 fuel contract – the 2008 Production Bonus Agreement discussed in the Audit Report at 2-20 through 2-24. (Supp. at 43 – 47.) If not considered unlawful retroactive ratemaking (which it should be), the decision to only adjust 2009 rates based on selective events in 2008 should alternatively be held as arbitrary, unjust, unreasonable, and against the manifest weight of the record.

As an example of its selective and arbitrary treatment, the decision below ignores the 2008 Production Bonus Agreement even though it, just like the Settlement Agreement, was entered into in 2008 for the sole purpose of avoiding defaults by AEP Ohio's coal suppliers that could have seriously impacted the Company's ability to provide service to its customers or to avoid even higher fuel costs in 2008 and the future. It does so even though the two agreements were executed within a month of each other and even though the beneficial effect of the Production Bonus Agreement extended beyond 2008. It ignores this other agreement even

though the Auditor determined, as applicable to both agreements, that AEP did an “exceptional job during this period, particularly with those suppliers that faced financial hardship.” (Audit Report at 1-4.) (Supp. at 18.) There is only one distinguishing reason for not viewing the 2008 Production Bonus Agreement the same as the 2008 Buyout Agreement – if the former is brought forward and realigned with 2009 fuel costs, as the Commission did with the latter, it reduces rather than increases any credit available to offset fuel charges prudently incurred in 2009.

The purpose and effect of the 2008 Production Bonus Agreement was fully documented in the record before the Commission. See Co. Ex. 2 (Rusk) at 17-20 (Supp. at 85- 88); Audit Report at 2-22 to 2-23 (Supp. at 45-46.) By entering into the agreement in February 2008, the Company assisted its largest coal supplier which was in jeopardy of being forced into bankruptcy. Due to the very high market price of coal at the time as compared to the price being paid under the prior agreement, the coal supplier believed that its lenders were attempting to take the company into bankruptcy, get the existing low-priced contracts (including AEP Ohio’s) rejected, and take the available coal to market to sell at the higher prices. The timing of the coal supplier’s threatened bankruptcy could not have been worse. Coal supplies were at very low levels and AEP Ohio would have been forced to seek replacement coal in a very expensive and volatile market. It would almost certainly have had to execute a multi-year deal just to get sufficient coal for the remainder of 2008.

In order avoid these consequences, AEP Ohio agreed to make a one-time \$28.6 million payment to the supplier in order to assure that the supplier remained in business and was able to provide coal at a below-market price levels during 2008 *and after*. The Auditor concluded in its report that “the . . . surcharge was a well considered decision in a difficult time” and that “while expensive, an insolvency of [AEP Ohio’s] largest supplier would have been more expensive.”

(Audit Report at 1-5.) (Supp. at 19.) The Auditor also concluded that “this decision was in the best interest of AEP Ohio ratepayers and commends AEPSC for its efforts.” (*Id.* at 2-23 to 2-24.) (Supp. at 46-47.) This commendable agreement in the “best interest of AEP Ohio ratepayers” increased AEP Ohio’s 2008 fuel costs by \$28.6 million, and, because there was no regulatory mechanism for recovering fuel costs in 2008, the payment reduced the Company’s 2008 earnings by that same amount.

The Commission could offer no valid rationale for its decision to ignore the Production Bonus Agreement while giving customers a forward credit of \$58 million to reflect the benefits of the 2008 Buyout Agreement. The sum and substance of its analysis is contained in paragraph 23 of its April 11, 2012 Entry on Rehearing. (Appx. at 39.)

The Commission first notes that the Auditor did not recommend that the Commission take in to consideration the 2008 Production Bonus Agreement or use it as an offset to the benefits accrued as a result of the settlement agreement. This is a weak excuse for the Commission’s incomplete analysis. The Commission has been delegated the authority to regulate electric utilities and their terms and conditions of service. It is the presumed expert and should not need an independent auditor to instruct it as to how it should perform its duty. The Commission should have seen for itself that, if it was going to modify its final Electric Security Plan Order in order to take into consideration pre-Electric Security Plan fuel contracts, it could not selectively look at only those contracts that provided value to AEP Ohio and ignore similar contracts that increased AEP Ohio’s costs. It should have known that a “heads-ratepayers gain; tails-Company lose” result is an unreasonable result.

The Commission fails to provide a record-based reason for its decision to ignore the Production Bonus Agreement. The Commission states: “Based on the generation rate increases

built into the rate stabilization plan in effect prior to the first Electric Security Plan in 2009, and the evidence of record in these proceedings, the Commission finds that the record does not support offsetting the adjustments to the deferred fuel costs for the settlement agreement, as directed in the fuel adjustment clause order, by the 2008 production bonus agreement.” (Appx. at 39.) This is a conclusory finding that does not cite to any portion of the record to support its conclusion. In fact, the only evidence of record in the proceedings on this issue was that discussed above – the Company’s explanation of the purpose and benefits accruing to ratepayers from the Production Bonus Agreement and the independent auditor’s praise of the Company’s decision to have acted “in the best interest of AEP Ohio ratepayers” at a significant cost to the Company. Nothing in the record would justify the elimination of consideration of this agreement if other agreements from outside of the audit period are going to be considered as part of this case.

The Commission’s reliance on the “generation rate increases built into the rate stabilization plan” as its justification for ignoring the Production Bonus payment is nothing short of mystifying in that the capstone of AEP Ohio’s 2006 through 2008 rate stabilization plan was the bundling of fuel and non-fuel rates and the establishment of fixed, pre-ordained generation rate increases that were not reflective of either the Company’s costs or earnings. *In the Matter of the Application of Columbus Southern Power Company and Ohio Power Company for Approval of a Post-Market Development Period Rate Stabilization Plan*, Case No. 04-169-EL-UNC, Opinion and Order at 16 (January 26, 2005). (Appx. at 191.) This bundling of fuel and non-fuel rates into a single generation rate was done specifically to stabilize generation rates during a time of market volatility and uncertainty for the benefit of customers and to help foster development of a competitive market for generation service all without regard to the Company’s cost or

earnings. *Id.* AEP Ohio accepted being “on its own” in the volatile fuel market and “at risk” with respect to the recovery of fuel costs during the rate stabilization plan period, but it did not accept or expect that years after the termination of the rate stabilization plan the Commission would cherry-pick the upside results of how it managed that risk (the value of the 2008 Buyout Agreement) while leaving behind the increased costs the Company incurred for the same purpose (the production bonus payment).

This Court has admonished the Commission that “[r]uling on an issue without record support is an abuse of discretion and reversible error.” *In re Application of Columbus S. Power*, 128 Ohio St.3d 512, 2011-Ohio-1788, 947 N.E. 2d 655, ¶29. It also has clearly instructed the Commission to “explain its rationale, respond to contrary positions, and support its decision with appropriate evidence. *Id.* at ¶30. The Commission’s decision to ignore the 2008 Production Bonus Agreement and selectively capture as a customer credit only the upside of how AEP Ohio managed the risk of volatile fuel costs in 2008, ignoring the downside to the Company, is without any record support and is devoid of any rational explanation for the Commission’s inconsistent treatment of the Company’s 2008 fuel contracts.

Proposition of Law No. II:

The seizure of the book value of the coal reserve component of the 2008 Buyout Agreement to offset fuel costs prudently incurred in 2009 is unlawful and unreasonable for the additional reason that ratepayers have no valid claim against this Company asset and there was no evidence presented to establish the current value of the coal reserve.

AEP Ohio contends that the seizure of any portion of the unrealized value of the 2008 Buyout Agreement is unlawful and unreasonable for the reasons already noted. The seizure of the value of the West Virginia coal reserve, at the \$41 million value booked when the 2008

Buyout Agreement was executed, is unlawful and unreasonable for the added reasons that the ratepayers have no entitlement to the value of this asset and that there is no record evidence to establish that the present value of the property is equal to the value of the asset as booked in 2008.

A. AEP Ohio's ratepayers have no entitlement to the value of the West Virginia coal reserve acquired through the 2008 Buyout Agreement.

Utility customers pay for electricity, not utility assets. Decades ago, the Commission settled the issue of whether ratepayers have an ownership in utility assets when Columbus Southern Power sold its ownership in a coal preparation plant for a gain in 1986. In that case, the Office of Consumers' Counsel (OCC) argued that ratepayers should receive a portion of the gain because fuel clause ratepayers had purchased an ownership interest in the plant's equipment through paying coal costs, which included a component for equipment rental, and, therefore, should reap the benefits of the sale of the plant. The Commission rejected OCC's argument stating that the ratepayers had not purchased an interest in the plant's equipment by paying for the coal costs. *In the Matter of the Regulation of the Electric Fuel Component Contained within the Rate Schedules of Columbus Southern Power and Related Matters*, Case No. 88-102-EL-EFC, Opinion and Order at 14-16 (Oct. 28, 1988) (Appx. at 230-32.) According to the Commission, "[t]he inclusion of an equipment rental component in the cost of coal does not confer the benefits or the risks of ownership of the equipment on those who pay [electric fuel component] rates which include the cost of the coal." *Id.* at 16. (Appx. at 232.) In its December 20, 1988 Entry on Rehearing (at 8), the Commission again concluded that it "has no doubt that the ratepayers were not purchasing an ownership interest in the equipment" through the fuel clause rates and the Commission asked the rhetorical question of whether OCC would be

before the Commission supporting a rate adjustment to the Company's favor based on this ownership theory had the equipment been sold at a loss. (Appx. at 251.)

The Commission's decades-old holding that customers do not acquire an ownership in utility assets when they pay rates for service applies here with additional force. In this case AEP Ohio's customers did not pay a separate fuel rate for generation service during the pre-Electric Security Plan period when AEP Ohio bore the entire risk of coal costs and acquired the West Virginia coal reserve as part of a buy-out of an unsustainable coal contract with one of its suppliers. Thus, there is no sound theory upon which it can be said that the Electric Security Plan ratepayers have a tenable claim to the coal reserve asset.

This Court has repeatedly admonished the Commission to "respect its own precedents in its decisions to assure the predictability which is essential in all areas of the law, including administrative law." *Cleveland Elec. Illum. Co. v. Pub. Util. Comm.*, 42 Ohio St.2d 403, 431, 330 N.E.2d 113 (1975). This means, of course, that the Commission should not change its position, particularly on such a fundamental issue as implicated here, unless "the need therefore is clear and it is shown that prior decisions are in error." *Id.* The Court's admonishment is reinforced by R.C. 4903.09 which requires the Commission to make specific findings and clearly set forth its reasoning in its written opinion. *See also, In re Application of Columbus S. Power*, 128 Ohio St.3d 512, at ¶30 (directing the Commission to always "explain its rationale, respond to contrary positions, and support its decision with appropriate evidence").

In this case, the Commission gave scant reason for rejecting its long-held and sound view that ratepayers do not have an ownership in utility assets. The Commission asserts that its precedent is not applicable here because its order does not "imply or recognize any ratepayer ownership interest in the coal reserve" but merely effects "the alignment of fuel costs with the

benefits of AEP-Ohio's fuel contracts." Entry on Rehearing at ¶29. (Appx. at 42.) This assertion is materially misleading by omission in that the order aligns 2009 fuel costs with a benefit from just one 2008 settlement agreement executed to salvage a doomed supplier relationship, while ignoring all other 2008 fuel related transactions. It also cannot be reconciled to the fact that the order takes the entire value of the coal reserve (however that value is ultimately determined) and transfers it directly to AEP Ohio's ratepayers. No fair label can be given to that transaction other than a transfer of ownership of this asset. The asset was once properly on the Company's books and, based on the Commission's decision, it has now been seized as a cash-equivalent asset of the ratepayers.

That the Commission's order turns the utility-customer relationship upside down is apparent. Electric utilities use their assets to produce electricity to sell to customers. Customers do not seize utility assets to pay for service. To fully appreciate the error in the Commission's reasoning the Court need only ask the same rhetorical question the Commission asked in Case No. 88-102-EL-EFC (the case discussed above involving the 1988 coal preparation plant gain). Entry on Rehearing at 8 (Appx. at 251.) Would the intervenors seek, and the Commission order, a realignment of 2009 fuel costs with the detriments of AEP Ohio's 2008 fuel contracts had the Company not entered into the Settlement Agreement, allowed the supplier to fail, and suffered a loss? The obvious answer is "of course not." Yet, if the Commission's realignment theory is lawful and reasonable, the Commission must be willing to apply it when there is a loss in value as well as when there is a gain. But that is not the position taken by the Commission in this case, as is apparent from its disregard of the effects of the Production Bonus Agreement.

B. The record does not support the Commission's determination that AEP Ohio's ratepayers should receive an immediate credit equal to the Ohio jurisdictional share of the \$41 million for the West Virginia coal reserve.

In its January 23, 2012 Order, the Commission determined (at 12) that "the \$41 million value of the West Virginia coal reserve that AEP-Ohio booked when the Settlement Agreement was executed" should be credited against the fuel adjustment clause under-recovery in 2009. (Appx. at 19.) The Entry on Rehearing clarified that the credit should be limited to only the Ohio jurisdictional share of this value but did not otherwise adjust the presumed value. (Appx. at 37.)

There is, however, absolutely no record support for the conclusion that \$41 million is a reasonable present value estimate of the coal reserve asset. The undisputed testimony was that the original booked value of the coal reserve asset was based on an October 2007 report done by an independent contractor and it was the only value known to AEP at the time the 2008 Buyout Agreement was executed and accounted for. (Cos. Ex. 6 (Rusk) at 4-5.) (Supp. at 94-95.) The Auditor did not do any valuation of the asset and could not confirm that the October 2007 value was an accurate present value of the coal reserve. (Tr. I at 37.) Most significantly the Commission itself concedes in its Order (at 12) that "the value of the West Virginia coal reserve is not clear." (Appx. at 19.) To rectify this glaring hole in the record, the Commission directs AEP Ohio to hire an auditor to determine whether there now is any "increased value," above the \$41 million which should accrue to AEP Ohio's customers. *Id.* Thus, in addition to illegally transferring this asset from the Company's books to the customers' pocket, the Commission compounds its error by ordering a minimum credit based on a presumed value it assumes is inaccurate, and then ordering that minimum credit to be further inflated if a subsequent audit shows any increase in value. The Commission issues this order notwithstanding the fact that the

actual value of the coal reserve could have decreased since the October 2007 – 2008 period when coal prices soared to an unprecedented high. The Court has held that “[r]uling on an issue without record support is an abuse of discretion and reversible error.” *In re Columbus S. Power*, 128 Ohio St.3d 512 at ¶29 (citing *Indus. Energy Users-Ohio v. Pub. Util. Comm.*, 117 Ohio St.3d 486, 2008-Ohio-990, 885 N.E.2d 195, ¶30). The Commission’s decision to turn the value of the Company’s West Virginia coal reserve into a cash credit for customers knowing that the presumed value is “not clear” falls far below the Court’s abuse of discretion standard.

Proposition of Law No. III:

The Commission lacks jurisdiction to modify its prior adjudicative decisions and can only exercise continuing jurisdiction to enforce final orders. *Ohio Consumers’ Counsel v. Pub. Util. Comm.*, 111 Ohio St.3d 300, 318(2006) ; *Ohio Consumers’ Counsel v. Pub. Util. Comm.*, 16 Ohio St.3d 9, 10 (1985).

The Commission’s adjudicative determinations cannot be re-litigated or re-applied on a retroactive basis and are *res judicata*. *Ohio Consumers’ Counsel v. Pub. Util. Comm.*, 111 Ohio St.3d 300, 318 2006-Ohio-5789, 856 N.E. 2d 213 (*res judicata* and collateral estoppel can apply to adjudicative Commission proceedings); *Ohio Consumers’ Counsel v. Pub. Util. Comm.*, 16 Ohio St.3d 9, 10, 475 N.E.2d 782 (1985) (same). As such, the Commission was precluded from revisiting these issues during the term of the ESP – including in this 2009 fuel adjustment clause Audit proceeding.⁴

⁴ By contrast, the Commission may *prospectively* change its prior decisions as a general matter, as long as it reasonably justifies the change. See e.g. *Ohio Consumers’ Counsel v. Pub. Util. Comm.*, 10 Ohio St.3d 49, 50-51, 461 N.E.2d 303 (1984). And the Commission may entertain what would otherwise be considered a collateral attack in the context of crafting a prospective remedy in a complaint case filed under R.C. 4905.26. *Allnet Comm. Servs., Inc. v. Pub. Util. Comm.*, 32 Ohio St.3d 115, 117, 512 N.E.2d 350 (1987). But those types of changes are only permissible if the decisional changes are made prospectively. And there is also an important

In the 1985 *Consumers' Counsel* case, the OCC challenged the Commission's decision to limit the refund of over-recovered system loss costs to the specific audit period under review. The Court held that OCC was barred from raising this argument because the Commission previously had reviewed the electric utility's fuel procurement practices, including the computation of system loss costs, during the period of time for which OCC sought a refund and found them proper. Neither OCC nor any other party applied for rehearing or appealed that prior order. The Court stated: "The inevitable conclusion from these facts is that OCC is barred by the doctrines of *res judicata* and collateral estoppel from attempting to relitigate the issue of the RFC rate which was previously determined to be proper. * * * * This question was directly at issue in the prior proceeding and was passed upon by the commission. OCC cannot now attempt to reopen the question." *Id.* at 10. This decision cements the conclusion that, while the Commission may have some limited authority to change its general positions when justified, it has no jurisdiction to change or modify an adjudicatory determination made in a prior final order. As discussed below, it is clear that the Commission violated these principles in multiple respects in the decision below.

A. It is unreasonable and unlawful for the Commission to retroactively modify its prior adjudicatory decision to establish annual fuel adjustment clause audits to examine fuel procurement practices and expenses for the audit period.

As referenced above, two of the key fuel adjustment clause issues adjudicated and decided in the *Electric Security Plan* cases were that: (1) the fuel adjustment clause mechanism would be limited to the ESP period, excluding both the pre-ESP period and the post-ESP period; and (2) annual prudence review of fuel costs would be conducted for fuel costs incurred in 2009,

legal distinction when it comes to changing an approved ESP plan; once an ESP is adopted under R.C. 4928.143 for a specified term, there is no indication that the General Assembly intended to allow the Commission to unilaterally change the ESP during that term.

2010 and 2011. (*Electric Security Plan*, Opinion and Order at 14-15.) (Appx. at 112-113.) In adopting the annual financial audit and prudence reviews, the Commission relied upon Staff witness Strom's testimony:

Additionally, Staff recommended that annual reviews of the prudence and appropriateness of the accounting of fuel adjustment clause costs be conducted (Staff Ex. 8 at 3-4) * * * Therefore, we find that the fuel adjustment clause mechanism with quarterly adjustments as proposed by [AEP Ohio], as well as an annual prudence and accounting review recommended by Staff, is reasonable and should be approved and implemented as set forth herein.

(*Electric Security Plan*, Opinion and Order at 14-15.) (Appx. at 112-113.) In the Staff testimony relied upon by the Commission in adopting the fuel adjustment clause mechanism, Mr. Strom described the annual financial audit and prudence review as follows:

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

(Staff Ex. 8 at 4.) (Appx. at 294.) Thus, there was to be an annual financial audit and prudence review for each of the three years of the ESP relative to fuel procurement activity covered by each audit period and the entire scope of the approved fuel adjustment clause is to be strictly limited to the three-year term of the ESP. These key matters involving operation of the fuel adjustment clause mechanism during the ESP were fully adjudicated and decided as part of the Commission's decision in the *ESP Case* – the determinations are *res judicata* and cannot be re-litigated or re-applied on a retroactive basis.

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

The RFP sets forth a three-audit cycle in the Rider fuel adjustment clause audit process. *Audit 1 will be the Rider fuel adjustment clause in place from January 2009 through December 2009.* The scope for Audit 2 will be the Rider fuel

adjustment clause in place during January 2010 through December 2010. The scope of Audit 3 will be the Rider fuel adjustment clause in place from January 2011 through December 2011.

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

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

The Auditor agreed during cross examination that the scope of a fuel adjustment clause audit is generally constrained to reviewing costs incurred during the audit period. (Tr. I at 58.) Ms. Medine also agreed that, audits are normally limited to the audit period because there are discrete periods of review applicable to each audit – the current audit reviews the prior year’s activities and the next audit reviews this year’s activity, and so on. (*Id.*) Just because there are long-term impacts of prior fuel-related actions of the Company, that does not mean that the prior rate plan should be abrogated or that the decision made by the Company under prior rate plans should be revisited.

The prior rate plan, the Rate Stabilization Plan (without a fuel adjustment clause), covered 2008 whereas the current rate plan, the ESP (with a fuel adjustment clause), covered

2009.⁵ The Commission adopted the fuel adjustment clause baseline (discussed in greater detail below) to transition from the RSP to the ESP and neither the ESP nor RSP decisions should be disturbed. Any fuel procurement decision made by AEP Ohio during the time AEP Ohio's fuel costs were unregulated should not be subject to prudence review or adjustment of any kind." Doing so now in order to address continuing costs or a decision from a prior review period is akin to disallowing a contract that was already subject to prudence review in a prior case. The two time periods associated with the two rate plans were distinct, involved different terms, and were adopted under different laws. The Commission's attempt to conflate the two periods is unreasonable and unlawful.

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

Nevertheless, the Commission's Opinion and Order reaches back into the prior RSP rate plan and extracts value from an arrangement (the 2008 Buyout Agreement) entered into when fuel cost recovery was unregulated and when there was no prudence review of fuel procurement activity. The Commission in essence revisited a procurement contract that had already been deemed prudent. The Commission attempted to address this error as follows:

⁵ Although the Commission has since adopted a new rate plan for AEP Ohio, the 2009-2011 Electric Security Plan (with a fuel adjustment clause) is referred to as the "current" rate plan for purposes of this appeal.

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

(Opinion and Order at 13.) (Supp. at 20.) Thus, the Commission once again attempts to rely upon its unsupported and (ironically) fictional "real economic cost" rationale to justify clawing back value from the prior rate plan for use as an offset against actual, prudently incurred, and accurately computed and recorded 2009 fuel costs. Fuel adjustment clause costs and revenue for a given period are based on actual accounting book costs. The Company followed generally accepted accounting principles accounting for these costs and revenues and no party challenged the accounting as improper. For the reasons provided above, this rationale is without basis.

B. By reaching back into 2008 and using the results of fuel procurement activities in 2008 to offset fuel costs prudently incurred in 2009, the Commission unreasonably and unlawfully modified the fuel adjustment clause baseline that was fully litigated and decided in a prior adjudicated decision of the Commission.

One of the key fuel adjustment clause issues litigated and decided in the *Electric Security Plan Cases* was to establish the fuel adjustment clause baseline as a one-time determination to put the pre-electric security plan period (*i.e.*, the rate stabilization plan period) fuel costs behind everyone and transition AEP Ohio from a non-fuel adjustment clause period to an active fuel adjustment clause period. Establishment of the fuel adjustment clause baseline was a hotly contested issue that the Commission adjudicated and decided – the fuel adjustment clause baseline is *res judicata* and cannot be re-litigated or re-applied on a retroactive basis. As such,

the Commission is precluded from revisiting these issues during the term of the electric security plan – including in this 2009 fuel adjustment clause audit proceeding.

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

In litigating the *Electric Security Plan*, there were widely varying recommendations as to the appropriate fuel adjustment clause baseline:

- Staff’s recommended using the 2007 actual fuel costs after adjusting them upward by the annual generation rate increases under the Rate Stabilization Plan, in order to calculate a proxy for 2008 fuel costs. (*Electric Security Plan*, Opinion and Order at 19.) (Appx. at 117.)
- The Company’s recommendation was based on a rate unbundling methodology starting with the 1999 rates and updating them through rate plan adjustments. (*Id.*)
- OCC recommended using 2008 actual costs and delay the decision if necessary. (*Id.*)

The Commission weighed the evidence carefully and found that “a proxy is appropriate to establish a baseline. Therefore based on the evidence presented, we agree with *Staff’s resulting value as the appropriate fuel adjustment clause baseline.*” (*Electric Security Plan*, Opinion and Order at 19 (emphasis added) (citing Staff’s Brief at 3).) (Appx. at 117.) In more explicit terms, the Commission specifically adopted Staff’s calculation that 2.625 cents/kWh would be the fuel adjustment clause baseline for CSP and 1.757 cents/kWh would be the fuel adjustment clause baseline for AEP Ohio. (*Electric Security Plan*, Nelson Rebuttal at 5.) (Appx at 259.)

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

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

(*Electric Security Plan*, Staff Initial Brief at 3.) (Appx at 261.) Thus, Staff suggested in their position (as expressly adopted by the Commission), that not only would setting the fuel adjustment clause baseline too low render the non-fuel adjustment clause rate too high going into the electric security plan, but a secondary effect of a baseline set too low would also be that the 2009 fuel adjustment clause rate impact or “bump” experienced by customers would be higher. Conversely, not only would setting the fuel adjustment clause baseline too high render the non-

fuel adjustment clause rate too low going into the electric security plan, but a secondary effect of a baseline set too high would also be that the 2009 fuel adjustment clause rate impact or “bump” experienced by customers would be lower. In addressing their claim that anything other than actual 2008 fuel costs would understate the fuel adjustment clause baseline, OCC witness Smith also raised the same two concerns in her testimony:

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

(*Electric Security Plan*, OCC Ex. 10 at 12-13.) (Appx at 263-264.) The Commission explicitly referenced this testimony in its Opinion and Order (at 19) in the *Electric Security Plan Cases*.

A third impact of the fuel adjustment clause baseline relates to the interaction of the first two impacts. Namely, the higher fuel adjustment clause baseline advocated by OCC and IEU would have resulted in a lower non-fuel adjustment clause generation rate and created more “head room” when the 2009 projected fuel costs were added to the non-fuel adjustment clause generation rate going into the electric security plan, so that a larger rate increase could have been implemented to achieve the actual rate levels approved in the *Electric Security Plan Case*. But the Commission adopted the lower fuel adjustment clause baseline advocated by Staff (which result was similar to the lower fuel adjustment clause baseline advocated by AEP Ohio, though based on a different methodology). In addition to creating a higher non-fuel adjustment clause generation rate, the lower fuel adjustment clause baseline adopted by the Commission resulted in less “head room” for the initial electric security plan rate increase. When this situation was coupled with the rate caps adopted as part of the electric security plan, it was a sheer certainty that large fuel deferrals would accumulate through implementation of the electric security plan. Notably, IEU understood all three of these related impacts and explicitly raised them on

rehearing in the *Electric Security Plan* cases, as IEU again advocated for use of 2008 actual fuel costs to establish the fuel adjustment clause baseline:

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

(*Electric Security Plan*, IEU Application for Rehearing at 12.) (Appx at 266.)

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

[T]he Commission has not adjusted the baseline for the 2009 period as decided in [AEP Ohio's electric security plan]. Rather, the Commission, in this case is engaging in a reconciliation and accounting which was explicitly contemplated by the ESP cases in future fuel adjustment clause proceedings. Otherwise, there would be no rationale for undertaking an annual audit. In this case, the Commission is making an accounting adjustment to recognize extraordinary events affecting 2009 costs such that the [AEP Ohio's] 2009 real costs will be comparable to the proxy baseline selected in [AEP Ohio's electric security plan].

(Opinion and Order at 13.) (Appx. at 20.) What the Commission did was not a proper reconciliation of costs incurred in a prior fuel adjustment clause period with those collected in a subsequent fuel adjustment clause period. In reality, what the Commission did, as a practical matter was to retroactively *modify* the fuel adjustment clause baseline established in the *Electric Security Plan* to a higher value. There was no reconciliation of actual incurred 2009 fuel costs to rates collected from ratepayers in 2009 – that is what a normal rate reconciliation does. Whether the 2009 fuel adjustment clause-related increase in rates were reduced through adoption of a higher fuel adjustment clause baseline (as was advocated by some intervenors in the *Electric Security Plan*) or through a reduction of the current under-recovery/deferral (as is being advocated by certain intervenors in this case), the financial effect on AEP Ohio is the same. In

any case, the Commission established the fuel adjustment clause baseline to put the prior no-fuel adjustment clause period behind everyone and transition to the ESP's active fuel adjustment clause mechanism and it unlawfully modifies the decision in the *Electric Security Plan* to now reach back into 2008 for purposes of adjusting prudently-incurred costs in the current 2009 audit period. The decisions on these issues are *res judicata* and collateral estoppel prevents intervenors from re-litigating and the Commission from reversing its decision regarding the same issues in this proceeding.

CONCLUSION

For the foregoing reasons, the Court should reverse and remand the Commission's decision below as specified above.

Respectfully submitted,



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CERTIFICATE OF SERVICE

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