ORIGINAL

IN THE SUPREME COURT OF OHIO

OHIO POWER COMPANY,	:	
Appellant/Cross-Appellee,	:	**Case No. 2012-1484**
v.	:	
THE PUBLIC UTILITIES COMMISSION OF OHIO,	:	**Appeal from the Public Utilities Commission of Ohio**
	:	**Public Utilities Commission of Ohio Case Nos. 09-872-EL-FAC 09-873-EL-FAC**
Appellee.	:	

THIRD BRIEF OF APPELLANT/CROSS-APPELLEE OHIO POWER COMPANY

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INTRODUCTION

The Commission argues (at 1) that this case revolves around a dispute about "the price of a ton of coal" which it asserts is a "purely factual matter" determined by the Commission based on entirety of what was exchanged in the 2008 Buyout Agreement. On brief, counsel for the Public Utilities Commission of Ohio (Commission) pejoratively argues that the Ohio Power Company (AEP Ohio) "wishes to split this transaction in two so as to keep the benefits of the settlement to itself and push the increased costs off on its customers." This allegation made on brief is not supported by any finding in the decision below. On the contrary, the Commission went out of its way in the decision below to conclude that "we do not find any motivation by [AEP Ohio] to transfer value from ratepayers during the ESP to an earlier date …" (Opinion and Order at 13, Appx. at 20.) More importantly, the Commission's claim that the 2008 Buyout Agreement increased 2009 fuel costs for ratepayers is inaccurate and conflicts with the manifest weight of the record. As will be demonstrated, the undisputed record evidence shows that AEP Ohio already credited against 2009 fuel costs an amount equal to the increase in 2009 costs associated with the 2008 Buyout Agreement; thus, ratepayers were already made whole for the impact on 2009 fuel costs associated with the 2008 settlement. Far from an attempt to "push the increased costs off on its customers," AEP Ohio had already voluntarily and proactively credited ratepayers the amount equal to the increased fuel costs for 2009 and it only retained benefits that related to the pre- S.B. 221 rate plan, the rate stabilization plan in effect in 2008, when fuel costs were unregulated.

In reality, it is the Commission that is attempting to improperly capture a windfall for ratepayers by confiscating Company property – even though the Company bore the risk of non-recovery of its fuel costs during the unregulated period, which was one of the most volatile periods of coal pricing in history. Unlike all prior fuel cases that are driven by actual costs and proper accounting, the Commission's "real economic cost" rationale is a subjective and arbitrary concept. AEP Ohio cannot keep its books and records based on an after-the-fact subjective view of what is later deemed to be the "true economic cost" and it is pure fiction for the Commission to attempt to impose such a standard.

To make matters worse, the Commission has improperly confiscated Company property in a selective and prejudicial manner by ignoring extraordinary fuel costs incurred by the Company during this same prior period. In the process of doing so, moreover, the Commission unlawfully abrogated its prior adjudicative decisions that were already final and non-appealable. This case is not a challenge to a factual finding of the Commission but presents important legal issues involving the well-established prohibition against retroactive ratemaking and the doctrine of *res judicata*.

LAW AND ARGUMENT

REPLY IN SUPPORT OF APPELLANT'S PROPOSITIONS OF LAW

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 – and the Commission selectively ignored extraordinary costs incurred by the Company during that same period.

A. **The decision to seize the remaining 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).**

The Commission attempts to refute AEP Ohio's claim of unlawful retroactive ratemaking by arguing (at 10) that the rates charged by AEP Ohio during the rate plan in effect in 2008 are "unaffected by the decision below" and (at 11) because "no refund is sought." The Commission, joined by IEU, argues that the decision below properly netted benefits of the 2008 Buyout Agreement[1] against 2009 fuel costs, which was proper and prospective ratemaking. Appellees ignore four key factors in making these faulty arguments: (1) the Commission's "real economic cost" construct violates the prohibition against retroactive ratemaking because it reaches back into the prior rate stabilization plan when fuel rates were deregulated, (2) the premise of offsetting the 2008 Buyout Agreement's impact on 2009 fuel costs is a factually erroneous pretext because the Company already made customers whole for the 2009 cost impact associated with the 2008 Buyout Agreement prior to the decision below, (3) the Company properly accounted for both the costs and benefits of the 2008 Buyout Agreement in accordance with the prior rate plan and there was no record basis to retroactively adjust the Company's 2008 accounting, and (4) the OAC "netting" rule relied upon by Appellees – as well as the underlying statutory provision it was based upon –are inapplicable and were applied retroactively by the Commission below.

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[1] The Commission and IEU refer to the 2008 Buyout Agreement as the 2008 "Settlement Agreement." AEP continues to refer to it as the 2008 Buyout Agreement to better distinguish it from the 2008 Production Bonus Agreement, which is also a settlement agreement.

1. The decision below constitutes unlawful retroactive ratemaking and the Commission's unlawful capture of benefits outside the period cannot be justified by a fictional "real economic cost" construct.

The Commission justifies the disallowance of the Company's full unrecovered 2009 fuel costs by quoting (at 11) its decision below as ordering a credit using proceeds from the 2008 transaction in order to reflect "the real cost of coal used … during the 2009 FAC audit period." In a similar fashion, IEU argues (at 23) that AEP Ohio simply "disagrees with the manner in which the Commission calculated AEP Ohio's FAC costs (net of benefits)." IEU concludes (at 24-25) that "the Commission properly determined that AEP Ohio's real cost of fuel is the price it paid for fuel minus any benefits AEP Ohio received." Thus, both Appellees advance the same gloss on this case: the Commission is merely looking at real economic cost or net cost of fuel for 2009, even though the Commission's method involves an incongruous macro-view of potential offsetting benefits from well before the audit period and ignores other substantial costs during the same period.

Factually, it is not disputed that the Commission's disallowance for the Company's full recovery of actual 2009 fuel rates was based on benefits received and accrued in 2008 during the prior rate plan and during a time period when fuel rates were deregulated. Though the Commission did not literally go back and reduce the rates charged in 2008 and no refund was ordered, the rate changes ordered in 2009 nonetheless relate back to 2008 and its "net cost" theory improperly captured financial benefits from 2008. As such, the Commission's restitution remedy violates the prohibition against retroactive ratemaking.

This Court has only recently admonished the Commission for engaging in retroactive ratemaking for a decision for prospective rates that "recouped losses" as if retroactive rate adjustments were made. *In re Application of Columbus S. Power*, 128 Ohio St.3d 512, 2011-

Ohio-1788, 947 N.E.2d 655, ¶ 10. The Court reinforced that its prior decisions under *Keco* and progeny "make plain that present rates may not make up for dollars lost" during the past. (*Id.* at ¶11.) Thus, the Court looked beyond the literal rate mechanics to determine that a prospective rate adjustment that yielded a "similar financial impact" to an actual retroactive rate adjustment was also prohibited as unlawful retroactive ratemaking. (*Id.* at ¶10.) In the case at bar, while the Commission's rate adjustment was prospective in a literal or mechanical sense, the intended and achieved financial effect was to retroactively capture benefits from 2008 for the purpose of improperly providing restitution to ratepayers relating back to the 2008 Buyout Agreement. The Commission's response that it only made prospective rate changes is not a sufficient defense to a retroactive ratemaking claim. The same circumstances in the *In re Application of Columbus S. Power* case caused the Court to find that the Commission engaged in unlawful retroactive ratemaking.

As a related matter, IEU's reliance on *Ford Motor Company v. Pub. Util. Comm.*, 52 Ohio St.2d 142, 149, 370 N.E.2d 468 (1977), is misplaced. IEU relies on *Ford Motor Co.* (at 22) to establish that a utility's right to revenue vests when the underlying service is rendered. AEP Ohio's complaint is that the Commission improperly reached back into 2007-2008 period when fuel rates were deregulated. Under the prior rate plan, AEP Ohio was entitled to collect the bundled generation rate without regard to fuel expenses incurred during that same period. AEP Ohio's right to collect the bundled generation rate in 2007-2008 vested in the period and the rates were collected and should not have been subjected to a future decision to claw back that value. Thus, the *Ford Motor Co.* decision actually supports AEP Ohio's position in this case.

The Commission (at 10-11) and IEU (at 25-26) also make a "red herring" argument that AEP Ohio agreed to have its fuel costs audited and to have the rates collected reconciled to actual costs incurred in 2009, relying on *River Gas Co. v. Pub. Util. Comm.*, 69 Ohio St.2d 509, 512-13, 433 N.E.2d 568 (1982). In this regard, Appellees misapply the Court's decision in *River Gas*, which involved the straightforward conclusion that a self-reconciling mechanism does not violate the retroactive ratemaking prohibition.

The *River Gas* case appears to be the first time the Court had considered an active fuel rider or reconciliation mechanism in light of the retroactive ratemaking prohibition and the decision refused to find that the gas cost recovery rate mechanism at issue amounted to retroactive ratemaking. *Id.* at 513-514. The Court reasoned that the gas cost recovery mechanism was the Commission-approved rate from its inception and that the tariff approved by the Commission required that supplier refunds *received during the period when costs were incurred* also flowed through the mechanism. *Id.* The requirement that supplier refunds be credited against gas costs was not only approved as part of the applicable tariff, but had also been contained in the municipal ordinances that predated the tariff provision. *Id.* at 511. The Commission decision in that case had found that the utility "was not treating these supplier refunds as required by [the tariff]" and ordered that the revenues received during the audit period be used to partially offset the fuel costs. *Id.* The *River Gas* Court agreed that the tariff "does not differentiate between supplier refunds on the basis of the period to which they relate" (but rather based on when the refund was received) and affirmed the Commission's decision. *Id.* at 514.

River Gas cannot be extended to this case because the fuel adjustment clause ("FAC"), which was first adopted and implemented beginning in 2009, cannot be a self-reconciling mechanism *for time periods prior to its creation.* Further, as discussed in Proposition of Law No. III, there is no basis to suggest that decisions implementing the electric security plan in 2009 and prior rate plan ever approved the FAC subject to reconciliation for costs and transactions that occurred outside of the audit period. (*See also* AEP Ohio Merit Brief at 27-31.) Although the *River Gas* holding and logic would conclude that there is no unlawful retroactivity where rider rates that were approved from inception as being subject to reconciliation and the Commission merely administered the reconciliation as approved, the situation in this case is much different: the Commission went well beyond the parameters approved when the FAC was established starting in 2009 and unlawfully reached back into 2007-08 when there was no FAC and no reconciliation requirement.

In sum, the *River Gas* case involved key facts and legal conclusions that are critically distinguished from the current case: (i) the benefits used to offset costs were received during the audit period, (ii) the tariff explicitly provided for crediting of these supplier refunds from its inception, and (iii) there was no deregulation of fuel during the prior period as the predecessor rate plan also reflected the requirement to provide refund credits. Thus, the *River Gas* opinion provides no authority to justify or defend the Commission's decision in this case and the Commission's and IEU's reliance on the decision is misplaced.

The fact that AEP Ohio's FAC rate is subject to reconciliation does not give the Commission a license to violate the prohibition against retroactive ratemaking; it merely means that the rate was approved subject to future audit and prospective reconciliation from the first day it was charged and there is no retroactivity violation for those features. AEP Ohio's complaint is not that costs incurred in 2009 should not be reconciled with rates collected, or benefits received, in 2009; rather, the Company's objection is that the Commission created a fictional construct of "real economic cost" as a smokescreen for reaching back into the period when fuel costs were deregulated to clawforward value properly attributed to the prior period. The Commission cannot do indirectly what it is prohibited from doing directly. *In re Application* *of Columbus S. Power*, 2011-Ohio-1788, at ¶ 10. Because the decision below had a "similar financial impact" as reducing rates properly charged under the prior rate plan and serves to confiscate benefits properly accrued by the Company during that prior period, the decision constitutes unlawful retroactive ratemaking and must be reversed or vacated. (*Id.*)

2. **The Commission's entire factual pretext for netting costs is inapplicable because AEP Ohio already made FAC ratepayers whole for the 2009 FAC rate impacts associated with the 2008 Buyout Agreement.**

The Commission's decision to offset the 2009 fuel costs by capturing the benefits accrued in 2008 was critically based upon an incorrect finding. The Opinion and Order found that the 2008 Buyout Agreement "resulted in OP ratepayers paying significantly more for coal beginning in 2009, the start of the ESP period, than would have been paid had the Settlement Agreement not been entered into." Opinion and Order at 12. (Appx. at 19.) Although the Buyout Agreement included a per ton price increase for coal delivered in 2009, the Commission's finding that the settlement resulted in ratepayers paying more fails to recognize the offsetting credit was, in fact, already voluntarily and proactively made by the Company. Consequently, the Commission's finding – along with the rationale for capturing the additional benefits – is fundamentally flawed.

On appeal, the Commission continues to invoke this false premise as a justification for its capturing of benefits received by the Company during the fuel deregulation period. The Commission claims (at 5) that ratepayers "will pay more per ton because Appellant pocketed the value inherent in the 1992 contract" terminated by the 2008 Buyout Agreement. Thus, the Commission argues (at 5) that it had to look to the "entirety of the transaction" in order to determine the "real economic cost of the coal during the audit period." IEU similarly argues (at 22) that the 2008 Buyout Agreement "increased the cost of coal that was consumed in 2009."

The premise that ratepayers paid more in 2009 for coal than they would have if the contract had not been terminated is false and conflicts with undisputed record evidence.

It is undisputed that the Company accounted for the costs and benefits of the 2008 Buyout Agreement, by allocating $13 million of the benefits to 2009 and 2010 such that FAC ratepayers received a credit for their jurisdictional share of that amount. Timothy Dooley, Director of Energy Accounting for AEP, testified that the Company had already credited $13.3 million of the total proceeds from the Buyout Agreement to be used to offset 2009 and 2010 fuel costs. This deferred credit for future (2009-2010) coal delivery was recorded during the first quarter of 2008, contemporaneously with the execution of the Buyout Agreement. (AEP Ohio Ex. 1, Dooley Test. at 3; IEU Supp. at 41.)

Significantly, Mr. Dooley testified (and no witness challenged his testimony) that the $13.3 million credit reflected "the net present value of the price differentials for future coal deliveries for 2009 and 2010 coal commitments when comparing the original contract (terminated under the settlement) and the new 2008 contract." (*Id.* at 4; IEU Supp. 42.) Of the $13.3 million attributed to future coal delivery, $7.5 million was estimated as the current portion for 2009 and $5.8 million was estimated as the long-term portion for 2010. (*Id.*) In other words, AEP Ohio already eliminated the 2009-10 effect of the Buyout Agreement on fuel costs for that same period by creating a deferred credit. The credit was equal to the difference between the price the Company would have paid for coal had the Peabody Contract not been terminated and the price it would pay in 2009 and 2010 under the new contract. Thus, Ohio ratepayers were not prejudiced by the Buyout Agreement because they were already made whole for the 2009 cost impact of the settlement. Consequently, the Commission's premise for capturing additional benefits of the 2008 Buyout Agreement was incorrect.

The fact that the Commission's main rationale for needing to address the 2009 cost impact is false further exposes that it went beyond any reasonable "net cost" theory by recapturing Company benefits from the prior rate plan. Stated differently, because the Company had already eliminated the 2009 fuel cost increase associated with the 2008 Buyout Agreement by providing an offsetting credit, it is even more obvious that the Commission's confiscation of the additional benefits from the prior rate plan is retroactive ratemaking. The Company's credit already placed ratepayers in the same financial position, for purposes of the 2009 fuel costs, they would be in had the 2008 Buyout Agreement not been entered into. Because ratepayers were held harmless, they were not entitled to an additional "windfall" at the expense of the Company – even focusing purely on considerations of fact and equity and setting aside the legal prohibition on retroactive ratemaking.

As a result of the deferred credit balance to be used to offset 2009-2010 fuel costs, the net fuel costs that were passed on to customers in 2009 were equal to what they would have been had the original contract not been terminated. The Commission's decision ignored this undisputed evidence and, instead, decided to reach back into 2008 and enrich customers at the expense of the Company in a manner that constitutes unlawful retroactive ratemaking. Consequently, the Commission's "net cost" rationale does not hold water for 2009 since the Company already offset the increase with a credit and the benefits captured by the Commission simply did not relate to 2009 fuel costs. In sum, because the Commission's pivotal reason for confiscating the Company's property was to redress the 2009 fuel cost increase resulting from the 2008 Buyout Agreement – even though the 2009 cost impact was already eliminated through the credit proactively implemented by the Company – there is no remaining justification for reaching back into the prior rate plan and capturing benefits of the Company.

3. **The Company properly accounted for the costs and benefits associated with the 2008 Buyout Agreement and there was no record basis to retroactively adjust the 2008 accounting.**

On brief, the Commission (at 12-13) asserts its regulatory authority over public utility accounting and maintains that it made an "accounting adjustment" in the case below, based on its view that "the better way to account for this renegotiation is to associate all the costs and benefits associated with each ton of coal with that ton of coal." As argued without qualification on brief (at 12-13), the Commission believes that it can make after-the-fact adjustments to the public utility's accounting. There is no basis in the record to conclude that the Company's accounting for the 2008 Buyout Agreement was improper and no witness testified that the Company's accounting was improper. The "better approach" explained by the Commission's legal counsel for the first time on appeal, including the rationale of being implemented to promote the accounting principle of matching, actually involves a gross mismatch of time periods. Even if this *ex post facto* rationalization can somehow be justified based on the record, however, it only serves to confirm that the Commission made a retroactive adjustment to the Company's 2008 accounting.

The Company accounted for the transactions involved in a manner consistent with Generally Accepted Accounting Principles (GAAP) –the same as they would have done had a fuel adjustment clause been in place during 2008. The Company properly allocated some of the proceeds of the 2008 Buyout Agreement to offset 2008 fuel costs and some of the proceeds to 2009 and 2010 (the latter flowed through the FAC that became effective in 2009). More specifically, AEP Ohio accounting witness Dooley filed direct and rebuttal testimony regarding the 2008 Buyout Agreement. (Co. Ex. 1, Sec. Supp. at 19-28; Co. Ex. 5, Sec. Supp. at 1-5.)[2] In November 2008, AEP Ohio recorded a debit to Account 141 (Note Receivable) and credits to Account 501 (Fuel Expense) and to Account 456 (Other Electric Revenues) in order to reflect the compensation received related to the coal supplier's failure to deliver the specified tons in 2008. (Co. Ex. 1 at 5, Sec. Supp. at 25; Co. Ex. 5 at 1-2, Sec. Supp. at 2-3.) Mr. Dooley testified that this accounting was appropriate under GAAP because the compensation received by AEP Ohio in November 2008 related to the shortfall of coal deliveries in 2008 and that otherwise would have been consumed in 2008; thus, the payment was properly recognized to income in 2008. (Co. Ex. 5 at 2, Sec. Supp. at 3.) The Company's accounting testimony was unrebutted and no party challenged the Company's 2008 accounting as being improper.

IEU witness Hess, who is an accounting expert that worked for the Commission as an accountant for decades, did not take issue with AEP Ohio's accounting in his testimony or on the stand. On the stand, IEU witness Hess definitively agreed that he was not "making an issue either with the GAAP accounting or the FERC compliance accounting." (Tr. II at 246, Sec. Supp. at 12.) Indeed, Mr. Hess repeatedly acknowledged that a Commission order would have been required to change the accounting in the manner he now advocates. (Tr. II at 247, 250-252, Sec. Supp. at 13, 16-18.) Mr. Hess also repeatedly acknowledged that special Commission approval would have had to be obtained at that time if the Company were to depart from GAAP accounting. (*Id.*) No other witness addressed the accounting issues.

The Commission's fast-and-loose claim on appeal that the "better approach" in keeping with the principle of matching glosses over the important fact that the impact of both the costs

[2] The Company's Second Supplement, filed concurrently with this Third Brief, contains the public version of testimony and hearing transcripts. The public version of the record is generally sufficient to support the points being cited but the Company understands and relies upon the fact that the Court already has the confidential version of the record.

and benefits of the agreement are spread out over several years and cannot fairly be captured just for 2009. The "real economic cost" approach taken by the Commission looked at a period of time that is broader than the 2009 review period of fuel costs and, of particular relevance here, into the 2007-08 period when fuel costs were deregulated. This mismatch of offsetting 2009 costs with 2007-08 benefits is unfair and unjustified, above and beyond retroactive ratemaking. Using a larger period of time to capture benefits has a biased and prejudicial effect when used to net against the actual fuel costs incurred in 2009. Moreover, costs from the 2007-08 period were not used in the netting process, so the result was inherently biased and unreasonable – especially given that fuel costs were deregulated under the prior rate plan and the Company was at risk for non-recovery of fuel costs during that period.

In sum, the Companies offered detailed testimony regarding the accounting associated with the transactions at issue and established that the accounting was done according to GAAP, which were the "rules of the road" applicable in 2008. (Co. Ex. 1 at 3-4; Sec. Supp. at 23-24.) This GAAP accounting treatment was appropriate and properly allocated a portion of the proceeds of the 2008 Buyout Agreement to offset 2008 fuel costs and a portion of the proceeds to 2009 and 2010 (the latter portion is being flowed through the FAC that became effective in 2009). (*Id.*) The only accounting testimony in the record dealing with these issues was provided by AEP Ohio and none of that testimony was rebutted or otherwise challenged. After-the-fact assertions do not provide record support to challenge AEP Ohio's accounting. Even if the Commission's after-the-fact adjustment is somehow found to be consistent with the record evidence, however, it would only confirm that the Commission made an improper retroactive modification to the Company's 2008 accounting.

4. The administrative rule relied upon by Appellees, Ohio Admin.Code 4901:1-35-03(C)(9)(a), is not applicable and was improperly applied retroactively.

Finally in this regard, the decision below and the Commission's brief on appeal both invoke an administrative rule, Ohio Admin.Code 4901:1-35-03(C)(9)(a), as additional authority to support its decision to retroactively capture benefit from the prior period of fuel deregulation. (Second Entry on Rehearing at 7; Appx. at 38; Commission Brief at Prop. IV.) IEU also argues (at 33) that the administrative rule supports the Commission's decision to offset 2009 fuel costs with revenues received under the prior rate plan in 2008. Both Appellees cite the Commission's entry on rehearing:

> Pursuant to the requirements of division (B)(2) of Section 4928.143, Revised Code, to include the FAC mechanism as a part of the first ESP, AEP-Ohio was required to include "in the application any benefits available to the electric utility as a result of or in connection with such [FAC] costs including but not limited to profits from emission allowance sales and profits from resold coal contracts."

Entry on Rehearing at 7, App. at 38. For the reasons discussed below, this rule is not applicable or controlling and is otherwise unavailing to justify the retroactive ratemaking below.

As a threshold matter, it is axiomatic that the Commission's administrative rules can only be promulgated and implemented in a manner consistent with Ohio law; thus, to the extent that the decision below is unlawful retroactive ratemaking, the rule cannot save the decision from reversal or *vacatur*. Second, the rule as written merely addresses filing requirements for an electric security plan application and does not impose any independent or substantive requirements. The resulting order adopting or modifying an ESP proposal is controlling over the scope and effect of the FAC mechanism.[3] Third, the text of the rule merely provides that benefits associated with the costs incurred shall be described in the ESP application. There is

[3] As discussed in Proposition of Law No. III, the decision below also improperly abrogates a prior adjudicative decision that was already final and non-appealable.

nothing in the rule disclosing that it would be used to capture benefits outside of the period in question or that would require such an unreasonable result. Fourth, the rule was not effective until after the time the Commission adopted the FAC for AEP Ohio in its ESP decision. Specifically, the rule became effective on May 7, 2009, but the Commission adopted the FAC on March 18, 2009. Thus, the decision below retroactively applied the rule. Fifth, the rule implements R.C. 4928.143, which become effective July 31, 2008 – during the period of fuel deregulation and well after the 2008 Buyout Agreement was executed and implemented. This also confirms that the rule and underlying statute were applied retroactively by the decision below.

In sum, the administrative rule relied upon by Appellees provides no support or defense of the Commission's retroactive ratemaking decision below.

B. If the Commission is correct in considering the value of the 2008 Buyout Agreement as an offset to 2009 fuel cost under-recoveries, then it must also consider the costs cost implications of the 2008 Production Bonus Agreement.

In its First Merit Brief, AEP Ohio explained why it is arbitrary and unreasonable for the Commission to selectively offset recovery of 2009 fuel costs by the value received from the 2008 Buyout Agreement while ignoring the 2008 Production Bonus Agreement that substantially increased fuel costs and reduced earnings in 2008. (See Merit Brief at 17 – 21.) The Commission and IEU make four points in response in an effort to justify ignoring the Production Bonus Agreement. None of their points has merit.

First, the Commission states (at 6) that there is "little clarity" to the Production Bonus Agreement and it cannot understand why AEP Ohio paid more to the coal supplier rather than insisting on its contractual rights. The Commission's observation ignores the record. There was ample testimony in the record as to the reason for the Production Bonus Agreement. This testimony is summarized at pages 17-18 of the AEP Ohio's First Merit Brief. Moreover, the Production Bonus Agreement was discussed at length in the independent auditor's report. (Supp. 19, 46-47.) The independent auditor concluded that the $28.6 million surcharge AEP Ohio paid in 2008 "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." (Supp. 19.) The independent auditor also concluded that the "decision was in the best interests of AEP Ohio ratepayers." (Supp. 46.) The clarity the Commission cannot see is readily found in the record.

Second, the Commission seeks to justify its decision to retroactively capture additional benefits of the 2008 Buyout Agreement while ignoring the costs of the 2008 Production Bonus Agreement by citing to Ohio Admin. Code 4901:1-3503(C)(9)(A), the rule which describes the information that must be included in an ESP application. The Commission argues (at 6) that it was appropriate for it to consider the "benefits" of the 2008 Buyout Agreement because this rule requires such benefits to be disclosed; and, conversely, that it was appropriate for it to ignore the costs associated with the Production Bonus Agreement because the rule is "silent as to losses."

What the Commission fails to appreciate, however, is that under its own "real economic costs" theory – the same theory that it invoked to claw forward the full value of the 2008 Buyout Agreement to offset 2009 fuel cost under-recoveries – the $28.6 million surcharge in the Production Bonus Agreement would have to be considered part of the 2009 net fuel costs. That is so because AEP Ohio paid that surcharge in 2008 in order to avoid having to pay the higher market prices going forwarded into 2009 and beyond as a result of the supplier's default. The independent auditor addressed this point as follows:

> The due diligence conducted by AEPSC confirmed that absent financial assistance, [Supplier] would effectively be insolvent. If [Supplier] were forced

> into bankruptcy, the below market contracts would most surely be rejected which would require AEPSC to pay a "market price" for the same coal. Throughout most of the period, the market price was in excess of the [renegotiated price]. Further any replacement contracts would have locked in the price increase.

(Audit Rpt. at 2-23.) (Supp. 46.)

IEU misses this point as well. It argues (at 28) that the Commission properly discounted the Production Bonus Agreement because that agreement, unlike the 2008 Buyout Agreement, affected only 2008 fuel costs and had no effect on 2009 fuel costs. As noted by the independent auditor, however, by paying the surcharge to keep the Supplier from filing for bankruptcy, AEP Ohio was able to keep the cost for coal supplied by this Supplier in 2009 below market level, even with the per ton increase for coal delivered in 2009. Thus, under the Commission's "real economic cost" construct the $28.6 million surcharge paid in 2008 would have to be considered a component of the net cost of fuel in 2009. While AEP Ohio does not agree with the Commission's "real economic cost" theory, and believes it constitutes retroactive ratemaking, if the Commission's theory is upheld to permit offsetting 2009 fuel costs by the value of the 2008 Buyout Agreement, it must be applied consistently and fairly to take into the account, and to recognize as part of the netting of costs and benefits, the costs associated with the 2008 Production Bonus Agreement.

Third, the Commission suggests (at 7) that it is entitled to ignore the losses associated with the Production Bonus Agreement in its real economic cost analysis because the Company did not expressly seek to recover these losses through the fuel adjustment clause. The Company did not seek to do so, of course, because it believed – and continues to believe –that the fuel adjustment clause in limited to the ESP period, *i.e.* fuel costs actually incurred in 2009, 2010 and 2011. It is only because the Commission's order ignored this limitation on the FAC, by reaching back into 2008 to bring forward the value of the Buyout Agreement, that the need to consider the losses associated with the Production Bonus Agreement became apparent. While AEP Ohio did not affirmatively seek recovery of the $28.6 million surcharge paid in 2008 to keep fuel costs in 2009 and later below market, the reason for, and amount of the surcharge, was presented in the proceedings below and was included in the independent auditor's report. Further, this claim was advanced in the testimony of AEP Ohio witness Nelson and addressed in the Company's application for rehearing. Thus, the Commission cannot rightfully claim there was a failure of proof that any adjustment is required under the Commission's "real economic cost" theory.

Fourth, for its argument on this issue, the Commission merely repeats (at 7) what it said in its Entry on Rehearing. AEP Ohio fully addressed the errors in the Commission's rehearing entry in its First Merit Brief at 19-21. The Commission makes no response to the points AEP Ohio raised. From this, the Court must assume the Commission cannot better justify its position. Particularly telling is the fact that the Commission again intimates (at 7) that there is a "distinct possibility that the rate plan which was in force during 2007 may have directly allowed Appellant to recover its losses under the Production Bonus Agreement." The Commission, however, again failed to explain what it means by this cryptic statement.

IEU attempts to bolster the Commission's conclusion regarding the recovery of fuel costs in the prior rate stabilization plan by stating (at 27) that AEP Ohio received "over $500 million in generation rate increases in its *RSP Case* alone." In making this statement IEU ignores one of the key tenets of the rate stabilization plan – that a fixed level of fuel costs was embedded in the rates and that the Company had all the risk to the extent costs rose above the threshold. Moreover, the amount AEP Ohio recovered through generation rates under the prior rate stabilization plan is irrelevant to Commission's "real economic cost" of fuel analysis.

Under the "real economic cost" theory, it is irrelevant when the revenue was received or the costs were incurred; the relevant transaction "straddles" the RSP and ESP periods. (Comm. Br. at 3.) See also Comm. Brief at 18 ("As that coal was sourced through a transaction that occurred both before and during the audit period, the Commission correctly considered both aspects of the transaction.") Thus, according to the Commission, if revenue was obtained during the pre-2009 ESP period but the transaction affected fuel costs during the ESP unfavorably, the revenue should be brought forward to offset fuel cost under-recoveries through the FAC. So too then, if a cost was incurred during the pre-ESP period, but the transaction affected fuel costs during the ESP favorably, the costs should be brought forward and considered in the netting process to produce the "real economic cost" of fuel in 2009. While AEP Ohio does not agree that the Commission "real economic cost" theory is lawful or appropriate, if the theory is upheld, it must be fairly applied and include the substantial Production Bonus Agreement cost from 2008.

IEU's argues (at 28) that the Commission could rightfully ignore the costs of the Production Bonus Agreement because it, unlike the Settlement Agreement, did not "straddle" 2008 and 2009. It making this argument, however, IEU looks only at the per ton price increase for coal delivered in 2009 and concludes that increase was recovered (properly) through the FAC. IEU ignores the indisputable fact that, but for the Production Bonus Agreement, the Supplier would have defaulted and AEP would have had to pay market prices in 2009, which prices would have been higher than the actual 2009 costs even with the per ton price increase. (Jt. Ex. 1, Audit Rpt. at 2-23; Supp. 46.) Thus, the $28.6 million surcharge is as much a part of the "real economic cost" of coal delivered in 2009 as is the price increase IEU and the Commission argue was properly passed on to retail customers.

The Court has held that the Commission has an obligation to "explain its rationale, respond to contrary positions, and to support its decision with appropriate evidence." *In re Application of Columbus S. Power*, 128 Ohio St.3d 512, 2011-Ohio-1788, 947 N.E.2d 655, ¶ 29. Because the Commission failed to meet this obligation with respect to ignoring the Production Bonus Agreement in its "real economic cost" analysis, the Commission's order must be found to be an abuse of discretion and reversible error.

<u>Proposition of Law No. II:</u>

> **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.**

It is First Merit Brief (at 21-26) AEP Ohio explained why the seizure of the book value of the West Virginia coal reserve transferred to AEP Ohio as part of the 2008 Buyout Agreement was unlawful and unreasonable for reasons beyond constituting retroactive ratemaking. This seizure of AEP Ohio's physical asset was unlawful because the ratepayers have no entitlement to this asset, beyond that already recognized in the deferred credit AEP Ohio previously booked to offset the increase in 2009 fuel costs resulting from the 2008 Buyout Agreement. The seizure of the remaining booked value of the coal reserve was unreasonable because, as the Commission itself recognized, the present value of the coal reserve was not known.

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

The Commission (at 17) and IEU (at 29) argue that AEP Ohio's second proposition of law is a red-herring because the Commission's seizure of the full value of the coal reserve did not equate to an assertion of ownership over the property. This response elevates the Commission's choice of words to characterize the seizure over the actual substance and effect of the seizure. AEP Ohio is not "mischaracterizing" the Commission's order. The Commission's order mischaracterized the substance of the coal reserve transaction.

The coal reserve was a physical asset acquired by AEP Ohio at a time when fuel cost were unregulated. The coal reserve was recognized on AEP Ohio's books as a debit to "non-utility property." (AEP Ohio Ex. 1, Dooley Test. at 3, IEU Supp. 41.) The independent auditor accepted the Company's accounting and no witness took issue with this entry. The Commission's order, however, took this physical asset owned by the Company and handed it over to Ohio retail customers in its entirety to offset 2009 fuel costs. The Commission, in effect, transferred possession of, and all rights in, this physical asset to ratepayers, even though the asset was acquired at a time when fuel costs and credits were completely unregulated and even though AEP Ohio has already aligned the benefit of this component of the 2008 Settlement Agreement with 2009 and 2010 fuel costs by the $13.3 deferred credit. The Commission's euphemistic statement that seizure of the full value of the coal reserve was merely "a realignment of fuel costs with the benefits of AEP-Ohio fuel's contracts," Entry on Rehearing at 11 (Appx. at 42) ignores the actual facts and record below.

The Commission at least acknowledges (at 17) that "ratepayers do not earn or acquire an ownership interest in the utility's assets as a result of paying for utility services." Unfortunately for the Company, the Commission went on to seize the Company's asset and effectively require liquidation of it for the benefit of ratepayers. IEU, however, takes issue with this fundamental principle, citing to the Commission's decision in the *Emission Allowance Case*, Case Nos. 98-101-EL-EFC, Opinion and Order at 12-15 (May 26, 1999). IEU argues that in the *Emission*

Allowance Case, the Commission rejected AEP Ohio's argument that customers had no ownership right in certain lower cost emission allowances AEP Ohio owned but was required to surrender to the USEPA. In making this argument, IEU mischaracterizes the Commission's decision. AEP Ohio raised the ownership issue discussed in the passage quoted by IEU (at 29) only because the independent auditor in that case had recommended that the surrender of the emission allowances should be viewed "as a sale of the allowances during the current audit period and that the difference between the book value of the surrendered allowances and the market value of those allowances flow through the reconciliation adjustment." (Opinion and Order at 14; IEU Appx. at 124.) AEP Ohio argued that the surrender of the emission allowances does not constitute a sale and that the sale analogy wrongly implied that retail customers had some sort of ownership right to the emission allowances. The Commission did not reject AEP Ohio's argument; it agreed with AEP Ohio that "there was no sale" and that, if the sale analogy was adopted, customers would receive a "windfall." *Id.* at 15. IEU (Appx. at 125.)

While the Commission in the *Emission Allowance Case* held that some remedial action was nevertheless warranted, it did so for two reasons not present in this case. It held remedial action was necessary because EFC customers had been harmed by the surrender of the emission allowances and because the independent auditor had found AEP Ohio's actions that lead to the surrender to be imprudent. *Id.* at 14. In this case, however, the independent auditor did not find any imprudence in the decision to buy out the coal contract and, indeed, was complimentary of AEP Ohio's handling of this difficult situation. (Jt. Ex. 1, Audit Rpt. at 1-4 through 1-5; Supp. 18-19.) The Commission also made an express finding in its Opinion and Order (at 13) that there was no imprudence. (Appx. 92.) In this case, the customers have not been harmed because AEP Ohio, through the $13.3 million deferred credit, made up the difference between the fuel costs that would have been incurred in 2009 had the buyout not occurred and the higher costs that were incurred. The remedial action AEP Ohio voluntary took in accounting for the $13.3 million deferred credit is the same remedial action the Commission ordered in the *Emission Allowance Case*. In that case, the Commission ordered only that AEP Ohio re-price an equivalent number of the highest cost emission allowances it purchased during the audit period to the lower value of the emission allowances it surrendered. Thus, IEU's reliance on the *Emission Allowance Case* is misplaced, and following the case only justifies what AEP Ohio had already done voluntarily to assure that customers were not harmed by paying higher rates in 2009 as a result of the 2008 Settlement Agreement – it does not justify what the Commission's decision did to retroactively capture benefits from a prior period when fuel costs were deregulated.

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.

The Commission did not respond to AEP Ohio's additional argument that the value the Commission assumed for the credit to ratepayers in 2009 for the West Virginia coal reserve (the Ohio retail jurisdictional component of $41 million) was improper and not supported by the record. Perhaps the Commission felt constrained to stay silent by its own admission that "the value of the West Virginia coal reserve is not clear." Opinion and Order at 12. (Appx. at 19.) IEU, however, argues (at 31-32) that the record supports the value assigned to the coal reserve and the Court cannot overturn the Commission's "factual determination" as to the value of the coal reserve. Curiously all IEU offers at the record support for this "factual determination" is testimony showing that witnesses in the proceeding did not agree that $41 million was the correct value, but some merely assumed it was a likely minimum.

As AEP Ohio argued and the independent auditor agreed, however, the "best way" to determine the present value of the coal reserve asset is to sell the asset in a true sale. *See* AEP Application for Rehearing at 14-15 (quoting testimony of the independent auditor at Tr. I at 116) (Appx. 75-76; Sec. Supp. at 9.) Thus, even if the Court affirms the Commission's decision to credit Ohio retail customers with their jurisdictional share of the full present value of the West Virginia coal reserve acquired in 2008, it should nevertheless remand the valuation issue to the Commission, instructing the Commission to value the reserve based on a true sale. It simply is not reasonable for the Commission to value the coal reserve using a number it knows is likely not right and then allow for a correction only if the true value is later to be determined to be higher. IEU's argument should be rejected because the Court need not give deference to a "factual determination" by the Commission that the Commission itself acknowledges is "not clear."

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).**

In response to AEP Ohio's argument that the Commission is bound by its prior adjudicative orders and cannot modify such a decision after it has become final and non-appealable, the Commission offers (at 15-16) two responses: (1) the Commission did not modify its prior orders since it "expressly rejected the claim that it was changing" the terms of the ESP, and (2) "[i]f the company is unhappy with the terms imposed by the Commission it may terminate" its ESP application as provided in the ESP statute. IEU's posture is similar, claiming (at 35) that "the Commission's determination was limited to AEP Ohio's actual fuel costs – a product of costs and related benefits" and asserting (at 37) that AEP Ohio "just does not agree with the manner in which the Commission calculated 2009 fuel costs." As demonstrated in AEP Ohio's First Merit Brief, however, the Commission did materially alter the ESP and the terms of the FAC in the decision below and the Commission's denial rings hollow. The Commission's "if you are unhappy, just terminate the plan" argument is also disingenuous, because the 2009-2012 ESP term has ended and a new plan exists today. Indeed, because the Commission did not issue a final order regarding 2009 fuel costs until mid-2012 and the decision remains pending on appeal, any exercise of the option to terminate or withdraw from the first electric security plan under R.C. 4928.143(C)(2)(a) is simply moot and unavailable. The only adequate remedy here is for this Court to mandate that the Commission follow its prior adjudicatory decisions without modification.

On brief, the Commission also argues (at 15) that the FAC is a rate recovery mechanism "wholly created by the Commission" and asserts (at 16) that the "scope and terms of the FAC proceeding are as the Commission has defined them." While these statements of bravado may accurately portray the Commission's overbroad view of its own authority, they are simply wrong. The FAC is statutory and this Court has already held that every rate provision adopted as part of an ESP must be based on one of the "laundry list" of provisions in division (B)(2) of the ESP statute, R.C. 4928.143. *In re Application of Columbus S. Power*, 2011-Ohio-1788 at ¶ 32.) The Commission explicitly relied upon division (B)(2)(a) when adopting the FAC in the ESP proceeding and that provision does not authorize the Commission to capture benefits from a prior rate plan or during a period prior to the enabling legislation even being enacted. (*Electric*

Security Plan, Opinion and Order at 14.) (Appx. at 112.) Thus, contrary to the Commission's sweeping declarations of its own authority on brief, the Commission is limited by the terms of R.C. 4928.143(B)(2)(a) in deciding a subordinate proceeding to implement the FAC and it is restricted from applying the statute in a retroactive manner as discussed above.

Other than flatly deny changing the prior order, Appellees have done nearly nothing to rebut the showing made in AEP Ohio's First Merit Brief (Proposition of Law No. III) that the decision below improperly abrogates two key determinations made in the now-final 2009 ESP decision: (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, 2010 and 2011. (*Id.* at 14-15.) (Appx. at 112-113.) ("we will limit our authorization, at this time, to the term of the [2009-2011] ESP.") As AEP Ohio demonstrated in its First Merit Brief as a matter of law, 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 St3d 9, 10, 475 N.E.2d 782 (1985).The Court should find that the Commission unlawfully abrogated its prior adjudicative decisions. Beyond referencing those points, AEP Ohio will not review its prior arguments and will continue to rely on its First Merit Brief to support this proposition.

RESPONSE TO IEU'S CROSS-APPEAL

<u>**Proposition of Law IV**</u>

The Commission properly clarified on rehearing that the 2009 FAC under-recovery need only be credited for the share of the Settlement Agreement allocable to Ohio retail jurisdictional customers.

IEU-Ohio's sole issue on cross-appeal is the issue raised in its fourth and final proposition of law – whether the Commission properly clarified that any of the additional remaining value from the 2008 Settlement Agreement credited to the 2009 FAC under-recovery should be limited to the share of the value allocable to Ohio retail jurisdictional customers. The Commission properly clarified that any such additional credit should be so limited. Such clarification is fully supported by the record below and is in keeping with one of the most fundamental principles governing state regulation of electric service – that the State's authority to regulate the provision of electric service is limited to regulating the provision of retail electric service in Ohio. This principle, commonly referred to as "jurisdictional allocation," means that when a utility, like AEP Ohio, sells it service at wholesale and to retail customers outside Ohio as well as Ohio retail customers, the expenses and revenues associated with its sale of service must be allocated for regulatory purposes to the three different jurisdictions (wholesale, non-Ohio retail and Ohio retail). IEU-Ohio's argument on appeal, on the other hand, is based on an elaborate, speculative theory that was not presented below, has no support in the record, and depends on a misreading of the Commission's *ESP 1* Order.

A. The record fully supports the Commission's conclusion that any further crediting of the value of Buyout Agreement should be based on a jurisdictional allocation.

The jurisdictional allocation issue was not in-play during the hearing phase of the proceeding below. It arose only because of an ambiguous statement in the Commission's Order. It is January 23, 2012 Opinion and Order, the Commission determined (at 12) that "all of the realized value from the Settlement Agreement should be credited against OP's FAC under-recovery namely the portion of the $ 30 million lump sum payment not already credited to OP ratepayers as well as the $ 41 million value of the West Virginia coal reserve that AEP booked when the Settlement was executed." (Appx. 19.) The reference to "all" was ambiguous because of the long-recognized principle of jurisdictional allocation and the fact that the amount already credited to Ohio ratepayers was known to be based on traditional jurisdictional allocation and that allocation had not been challenged in the proceedings. Accordingly, AEP sought clarification in its Application for Rehearing. (Appx. 62, 73-75.) The Commission, over IEU's objection, agreed with AEP's position, by clarifying (at 6) that:

> AEP-Ohio witnesses and the financial auditor recognized that fuel expenses are allocated between Ohio retail expenses, non-Ohio retail expenses, or wholesale expenses. The same is true regarding the allocation of revenues. Therefore, we find that the record includes sufficient evidence to justify presentation of the claim by AEP-Ohio. We clarify that the 2009 FAC under-recovery need only be credited for the share of the settlement agreement allocable to Ohio's retail jurisdictional customers.

(Appx. 37.)

The record testimony referred to in the Commission's Entry on Rehearing was clear and was never contradicted. As discussed above, AEP accounting witness Dooley established that the Company had already credited $13.3 million of the total proceeds from the Buyout Agreement to be used to offset 2009 and 2010 fuel costs. (AEP Ohio Ex. 1, Dooley Test. at 3; IEU Supp. at 41.) As a result of the deferred credit balance to be used to offset 2009-2010 fuel costs, the fuel costs that were passed on to customers in 2009 were equal to what they would have been had the original Peabody contract not been terminated.

The record also was clear, however, that Ohio retail customers were not entitled to receive the full value of the deferred credit balance attributable to the Buyout Agreement, but rather could properly receive only their fairly allocated share of the total. Mr. Dooley testified to the need for such jurisdictional allocation. (Tr. I at 122, Sec. Supp. at 10.) AEP Ohio witness Philip Nelson also testified to the need for a jurisdictional allocation of fuel credits as well costs by explaining:

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

(AEP Ohio Ex. 3 at 8.) (Supp. at 108.) Again, no witness contradicted this testimony and no party challenged the jurisdictional allocation of the deferred credit balance as entered on AEP Ohio's books in 2008.

The independent financial auditor retained by the Commission also supported the Company's position on this issue by his testimony that the fuel adjustment clause is limited to that portion of AEP Ohio's overall fuel expenses that relate to the Ohio retail customer jurisdiction. (Tr. I at 15-16, Sec. Supp. at 7-8.) Significantly, the financial auditor's function was to confirm that the Company properly calculated and accounted for the FAC (Supp. at 15), and the financial auditor found no issues or problems in the jurisdictional allocation.

The question of whether a jurisdictional allocation of costs and revenue is appropriate, and how such allocation is to be carried out, is a question of fact. See e.g., *In re Application of Columbus S. Power Co.*, 2012-Ohio-5690, 2012 WL 6553454, ¶ 47-50. To overturn the

Commission on a question of fact, IEU must show that the order is "so clearly unsupported by the record as to show misapprehension, mistake, or willful disregard of duty." *Id.* at 51 (citing, *AT&T Communications of Ohio, Inc. v. Pub. Util. Comm.*, 88 Ohio St.3d 549, 555, 728 N.E.2d 371 (2000)). IEU has again failed to meet this standard. In this case, it can cite to no record support for its claim that Ohio ratepayers should receive the entire value of the Buyout Agreement carried forward to 2009 and that none should be allocated as a credit against fuel costs associated with wholesale sales or non-Ohio retail sales.

B. The Commission's decision is consistent with well-settled law.

The Court has consistently upheld Commission's decisions that involve the necessity for the jurisdictional allocation of utility expenses and revenues. See Fourth Entry on Rehearing at 6 (Appx. at 59) ("As in many cases before the Commission, it is necessary that certain allocations be made so that only the accounts, property, expenses and revenues, and so forth associated with rendering service to jurisdictional customers are included within the scope of the proceedings."). It did so, for example, in *Ohio Edison Co. v. Pub. Util. Comm.*, 63 Ohio St.3d 555, 556, 589 N.E.2d 2d 1292 (1992), when it upheld the Commission' decision to allocate deferred costs associated with the construction of a generating unit, stating: "This allocation was necessary to separate costs incurred with respect to retail sales of electricity, which are recoverable from ratepayers in this proceeding ("jurisdictional sales"), from costs incurred with respect to wholesale sales, which are subject to regulation by the Federal Energy Regulatory Commission ("nonjurisdictional sales)." The necessity for jurisdictional allocation of costs and benefits is not limited to traditional cost of service ratemaking, but rather has carried forwarded into the post-S.B. 221 era. Thus, for example, the Court upheld the Commission's decision to exclude off-system sales from Columbus Southern Power's earnings in its application of the significantly excessive earnings test, required by R.C. 4928.143(F). *In re Application of Columbus S. Power Co.*, 2012-Ohio-5690, ¶ 35-40.

That the necessity for jurisdictional allocation of expenses and revenue carries forward into the post-S.B. 221 era is not surprising because the foundation for state regulation remains unchanged. The simple fact is the General Assembly has no authority under Ohio law to regulate the provision of retail service in other states and no authority to regulate the provision of the wholesale sale of electric power. These jurisdictional barriers apply regardless of whether the Commission is setting rates using traditional cost of service regulation or approving rates proposed in an electric security plan authorized in R.C. 4928.143. R.C. 4928.143 is one means by which an Ohio electric distribution utility may satisfy its post-S.B. 221 obligation to provide "default generation service" under R.C. 4928.141. The statutory default generation service obligation is the obligation to provide "a standard service offer of all competitive *retail electric services* necessary to maintain essential service to customers, including a firm supply of electric generation service." R.C. 4928.141(A). For purposes of R.C. Chapter 4928, "retail electric service" is defined as:

> any service involved in supplying or arranging for the supply of electricity to ultimate consumers in this state, from the point of generation to the point of consumption. For the purposes of this chapter, retail electric service includes one or more of the following "service components": generation service, aggregation service, power marketing service, power brokerage service, transmission service, distribution service, ancillary service, metering service, and billing and collection service

R.C. 4928.01(A)(27). Similarly, the Commission's jurisdiction over the FAC, a component of the ESP, is limited to regulating the "cost of fuel used to generate electricity supplied under the [SSO]." R. C. 4928.143(B)(2)(a).

Because the Commission's authority to regulate the sale of electric generation service is limited by state law to regulating "retail electric services" to "consumers in this state," it would have been unlawful as a matter of state law for the Commission to require revenue associated with non-Ohio retail or wholesale generation output to be used as a credit to offset fuel costs for Ohio retail service.

Moreover, with respect to the wholesale sale of electric generation service, any state regulation is expressly prohibited by federal law. Under well-established federal statutory and constitutional law, there is a "bright-line" between wholesale power transactions and retail transactions. *Mississippi Power & Light v. Mississippi*, 487 U.S. 354, 374, 108 S.Ct. 2428, 101 L.Ed. 322 (1988); *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953, 106 S.Ct. 2349, 90 L.Ed.2d 943 (1986). It is this federally-created "bright-line" that gives rise to the need to allocate total company revenues and expenses between an electric utility's wholesale business and retail business. *Ohio Edison v. Pub. Util. Comm.*, 63 Ohio St.3d at 556. The result IEU seeks on appeal would unlawfully cross the line to the extent Ohio retail customers are credited with asset value properly attributable to Ohio Power's wholesale generation output.

The only legal authority cited by IEU to support its fourth proposition of law is Ohio Admin. Code 4901:1-35-03(C)(9)(a)(ii), which requires an electric utility seeking to include in its electric security plan a provision of the automatic recovery of fuel costs to include in its application for its plan "any benefits available to the electric utility as a result of or in connection with such costs." IEU's reliance on this rule to suggest that all the benefits arising from the Buyout Agreement must be credited to Ohio retail customers is clearly misplaced. The Commission cannot exceed its statutory authority, which is limited to regulating retail electric service to Ohio consumers, by adopting a rule purporting to give it broader authority. And, it did not do so in this case. Of course, the Commission is a creature of statute and cannot create authority that it does not already have based on the Revised Code. *Discount Cellular v. Pub. Util. Comm.*, 112 Ohio St.3d 360, 372, 2007-Ohio-53, 859 N.E.2d 957, ¶ 51.

In any case, the reference to "electric utility" in this rule is defined in Ohio Admin. Code 4901:1-35-01(E) as having the same meaning as set forth in R.C. 4928.01(A)(11). R.C. 4928.01(A)(11) defines electric utility to mean a company providing "retail electric service in this state." As noted above, "retail electric service is defined to include only "service involved in supplying or arranging for the supply of electricity to ultimate consumers in this state." R.C. 4928.01(A)(27). Thus, the rule, properly read, is entirely consistent with Ohio law and with federal law – it requires the electric utility to include only the benefits available to it as a result of or in connection with fuel costs properly allocable to its Ohio retail generation output. Moreover, the Commission also relied upon Ohio Admin. Code 4901:1-35-01(E) in reaching the decision and clearly does not subscribe to IEU's broad interpretation of the Commission's rule. *Weiss v. Pub. Util. Comm.*, 90 Ohio St.3d 25, 17, 734 N.E. 2d 775 (2000). Rather, the benefits rule can only be lawfully interpreted as being limited to retail jurisdictional benefits, to the extent it can be applied to this case at all.[4]

C. IEU's elaborate theory that the Peabody Contract would have been used to produce electricity solely for SSO consumers was not presented below, has no support in the record, and is unfounded.

IEU's cross appeal is based on a labyrinth of extrapolations and suppositions cobbled together for purposes of this appeal. It never presented these extrapolations or suppositions to Commission in the proceedings on rehearing below. In sharp contrast to the elaborate representations, assumptions and calculations set forth a pages 12-16 of its Merit Brief to support

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[4] *See* Appellant's Proposition of Law No. I.A.4, *supra*.

its claim (at 40) that the "below-market Peabody Contract would have been used to produce electricity [solely] for SSO customers," IEU's presentation below was terse and conclusory. The only foreshadowing of what has grown into the elaborate theory that all the Peabody coal deliveries in 2009 would have been consumed at the Mitchell generating station and inured to the exclusive benefit of Ohio retail customers is the following passage from its ten page application for rehearing:

> In *ESP I*, the Commission authorized OP to establish the FAC. In return for granting OP a dollar for dollar recovery mechanism, the Commission required OP to allocate its lowest cost fuel to SSO customers. OP has not claimed that the Supplier Contract at issue in this proceeding was not OP's lowest cost fuel source. Based on the Commission's July 23, 2009 Entry on Rehearing is ESP I, the below-market Supplier Contract would have been fully allocated to the Ohio retail jurisdiction. Accordingly, any benefits obtained from renegotiating the Supplier Contract should also have been allocated 100% to Ohio retail jurisdictional customers.

(IEU Application for Rehearing at 7-8.) (IEU Appx. at 56-57.) The application for rehearing was based solely on argument, unadorned of any record support. Because the maze of representations, assumptions, extrapolations, and calculations IEU now presents as "facts" was never presented below, was never supported by a witness, was never subject to cross-examination, and was not evaluated by the Commission, the Court should reject much of IEU's fourth proposition of law on the grounds that it was not properly preserved for appeal. A party is not permitted to create new facts and theories for the first time on appeal. *Discount Cellular, Inc. v. Pub. Util. Comm.*, 2007-Ohio-53 at ¶ 59. Assuming, however, that the Court deems it necessary to fully consider IEU's fourth proposition of law, it should reject it because it is based on sheer speculation and a misreading of the order on which IEU's theory is based.

This Court has held that "speculative" arguments, which turn on questions of fact, "demanding substantial expertise in utility operations, accounting and finance to answer," simply "cannot succeed." *In re Application of Columbus S. Power Co.*, 2012-Ohio-5690, ¶ 48. That is the necessary outcome because the Commission's determination of a question of fact cannot be overturned unless it is "so clearly unsupported by the record as to show misapprehension, mistake, or willful disregard of duty." *Id.* at ¶51. This principle applies in spades to IEU's fourth proposition of law.

IEU has manufactured the theory set forth (at 10-16) of its "Statement of Facts" almost from whole cloth. Extrapolating from isolated statements in the Audit Report and general industry studies not included in the record below, IEU presents a series of its own calculations (calculations not presented in the record below) to build a case for its conclusion (at 14) that "[h]ad AEP-Ohio not terminated the Peabody Contract, the Mitchell generating station would have burned the least cost coal (per MMBtu) in the AEP-Ohio fleet in 2009." It then jumps the reader to the conclusion (at 16) that "[a]ccording to AEP-Ohio's allocation process, the lower priced electricity and associated fuel at the Mitchell generating station would have been allocated exclusively to retail customers." It then glosses over the total lack of actual record support for its theory, by arguing (at 17) "AEP-Ohio did not submit evidence indicating that this result would not have occurred in the absence of the Buyout."

IEU's theory is rife with speculation and supposition. While it purports to be based on what "logic dictates," IEU itself concedes (at 12-13) that several of its factual representations would be true only if "all other things being equal." For example, IEU argues in its Statement of Facts: "Logically, all other things being equal, if a generating unit requires less coal to produce a kilowatt hour of electricity, the generating unit will have a lower average dispatch cost." It also argues, quoting a 2008 industry report not in the record, "[o]ther things (most importantly, fuel and environmental compliance costs) being equal, the lower a power plant's heat rate, the higher it will stand in the economic dispatch priority order." It also argues, "[a]ll other things being equal, the lower the price of each Btu, the less it costs to produce a kilowatt hour of electricity." All these statements are necessary building blocks in IEU's new "matching" theory." Yet, there was no testimony as to these suppositions, and there is no reason to believe that "all other things are equal" in this complex area of dispatching and allocating generation output.[5] Gaps in the facts means gaps in the logic.

There are, however, even more glaring holes in IEU's theory than the assumptions and calculations it passes off as "fact." Three of the key premises for IEU's theory are contradicted by the record itself. First, IEU's theory is premised on the continuation of the Peabody Contract in its original form. There is no evidence to support the premise that the 1992 Peabody Contract would have continued into 2009 or 2010 without any renegotiation or modification. Company witness Rusk testified that the contract was unsustainable and that the likely result, absent the Buyout Agreement, was that Peabody would have defaulted and Ohio Power would have had to procure replacement cost at the higher market price. (Co. Ex. 2 at 13, 15-16; Supp. 81, 83-84.) While the auditor disagreed that a default was inevitable based on Peabody's financial condition (IEU Supp. at 58-59), the independent auditor recognized that Peabody initiated the buyout

[5] For example, as the Commission is well aware, AEP Ohio participates in a generation power pool with its sister operating companies in a seven-State region known as AEP-East. Generation dispatch and fuel procurement decisions are made on a "Pool" basis and are not driven by AEP Ohio's needs alone. Even within AEP Ohio, there is a separate jurisdictional "carve out" for the generation and fuel needs of the Wheeling Power division, which operates in West Virginia. The Wheeling and Pool transactions are firm power contracts approved by the Federal Energy Regulatory Commission and they certainly do not have "least favored nation" status such that they would receive the highest cost power, as IEU's sweeping assumptions would suggest. In addition, coal contracts are not allocated on a least cost basis, since there are many factors that determine where a particular procurement of coal is used – such as heat rate of the unit, variable costs of the unit, transportation costs, etc. In short, IEU's "all else being equal" assumptions are flawed and the sweeping conclusions reached by IEU's extensive extra-record assertions cannot be relied upon by this Court.

agreement because the contract price was "significantly below market" and had asserted a "legal claim as to the viability of the contract." (Jt. Ex. 1, Audit Report at 2-20; Supp. at 43.) The Audit Report also found that the buyout of the existing Peabody contract and the renegotiation of new contract terms for 2009 and later years was a prudent decision. (Jt. Ex. 1, Audit Rpt. at 1-4 through 1-5; Supp. 18-19.)

Second, IEU assumes that had the original 1992 Peabody contract continued into 2009, all the coal delivered under that contract would have been consumed by a single generating unit – the Mitchell generating station – to supply power to only SSO customers. There is no record support for this conclusion. IEU cites to its witness' testimony to support its conclusion (at 14-15, n.51) that "[t]he Peabody contract, however, would have provided the Mitchell generating station 1.8 million tons of coal [during 2009]." But the witness made no such connection; the cited testimony stated only that "[a]s a result of the early termination of the contract, OP had an open coal supply position that resulted in it purchasing 1.8 tons of coal." (IEU Supp. at 33.) While it is true that the original Peabody Contract, executed in 1992, was to supply coal to the Mitchell generating plant, (Supp. 19) (IEU Appx. at 155), there was no testimony to support the conclusion that all coal delivered under the re-negotiated contract in 2009 would be consumed by Mitchell. And , in fact, there was testimony that the coal delivered in 2009 under the new 2008 contract was delivered to AEP Ohio "generating plants," not exclusively to the Mitchell generating station. (AEP Ohio Ex. 1, Dooley Test. at 4; IEU Supp. at 42.)

Third, IEU's matching theory ultimately depends on the accuracy of its premise the *ESP1* Order required AEP to allocate its least cost fuel *source* to Ohio retail customers. The Commission concluded in its Fourth Entry on Rehearing, that IEU's position was based on a misreading of the *ESP 1* Order. (Appx. 59.) The Commission's interpretation of its own prior orders is entitled to great deference. The principle that the Court will give special weight to Commission's interpretation of statutes that deal with "highly specialized issues," should apply with even greater force when the Commission is interpreting its own orders. *In re Application of Columbus S. Power Co.*, 2012-Ohio-5690, ¶ 36; *City of Cleveland v. Pub. Util. Comm.*, 667 Ohio St.3d 446, 451, 424 N.E.2d 561 (1981).

The Commission explained that the reference in its July 23, 2009 Entry on Rehearing in *ESP 1* to AEP continuing its procedures for allocating fuel costs to SSO customers "on a least cost basis" meant that AEP was to allocate fuel costs to SSO customers based on "the average dispatch cost associated with a unit for a particular period of time, rather any one particular supply contract." (*Id.*) The plant stacking process that is used to identify the average dispatch cost depends on many complex factors, including heat rates and other variable costs, in addition to the contract price for the coal actually consumed by the unit during the particular period of time. In sum, the Court should reject IEU's cross appeal because the elaborate theory it now raises for ignoring the long-standing principle of jurisdictional allocation was not adequately preserved for appeal and is not support by the record or by the law.

CONCLUSION

For the foregoing reasons, the Court should grant Appellant's appeal and deny Cross-Appellant's claims, as specified above.

Respectfully submitted,

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CERTIFICATE OF SERVICE

The undersigned counsel certifies that Ohio Power Company's Third Brief was served by First-Class U.S. Mail upon the following counsel of record this 21st day of February 2013.

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