

ORIGINAL

IN THE SUPREME COURT OF OHIO

OHIO POWER COMPANY,)	Supreme Court Case No. 2012-2008
)	
Appellant/Cross-Appellee)	Appeal from the Public Utilities
)	Commission of Ohio
v.)	
)	
THE PUBLIC UTILITIES COMMISSION)	
OF OHIO,)	
)	PUCO Case Nos. 11-4920-EL-RDR and
Appellee)	11-4921-EL-RDR

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I. INTRODUCTION

In the proceeding below, the Public Utilities Commission of Ohio (“Commission”) established carrying charge terms to apply to the amortization of amounts that were deferred in Ohio Power Company’s (“OP”) and Columbus Southern Power Company’s¹ (“CSP”) (collectively, “AEP-Ohio”) first electric security plan (“ESP”) case. To ensure that the phase-in remained just and reasonable, the Commission directed AEP-Ohio to accrue carrying charges at a long-term debt rate. The Court should uphold that determination.

The Commission, however, failed to direct AEP-Ohio to make an adjustment to the deferred amounts to account for tax benefits prior to calculating carrying charges. Moreover, the Commission failed to direct AEP-Ohio to account for the flow-through effects of the remand of AEP-Ohio’s ESP. The Commission’s determinations are unlawful and unreasonable; thus, the Court should reverse and remand this proceeding to the Commission to correct the errors identified herein.

II. STATEMENT OF FACTS AND BACKGROUND

In its Merit Brief, AEP-Ohio asserts that the Commission unreasonably or unlawfully modified a finding of fact which the Commission made in AEP-Ohio’s first ESP case.² This assertion is without merit.

Among other things and in reliance on R.C. 4928.144, the ESP Opinion and Order authorized AEP-Ohio to defer collection of a portion of the increase the Commission authorized

¹ OP and CSP have merged.

² AEP-Ohio Merit Brief at 1-7.

in the proceeding.³ The Commission's ESP I Order also specified the carrying charge or capitalized interest that AEP-Ohio was allowed to add, during the deferral period (the "Deferral Period"), to the deferred increase. The Commission's ESP I Order did not address the amount of any additional carrying charges or capitalized interest that AEP-Ohio could collect in the future once the amortization of the deferred balance commenced (the "Recovery Period"). Rather, the Commission's ESP I Order directed AEP-Ohio to file a subsequent application to address the terms and conditions that would control the amortization of the deferred portion of the *ESP I* increase.

A. The ESP I Order

On March 18, 2009, in AEP-Ohio's first ESP case, the Commission authorized AEP-Ohio to increase rates by a total dollar amount.⁴ A portion of that total increase was collected during the term of the ESP and a portion was deferred for potential future recovery through a non-bypassable rider after the end of AEP-Ohio's ESP, subject to necessary adjustments. At the

³ The total amount of the increase approved by the Commission included a provider of last resort ("POLR") charge which this Court and the Commission subsequently found to be unlawful. *In the Matter of the Application of Columbus Southern Power Company for Approval of an Electric Security Plan; an Amendment to its Corporate Separation Plan; and the Sale or Transfer of Certain Generating Assets*, Case Nos. 08-917-EL-SSO, *et al.*, Opinion and Order at 20-24, 40 (Mar. 18, 2009) (AEP-Ohio Appendix at 102-106, 122) (hereinafter referred to as "AEP Appx.") (the proceeding is hereinafter referred to as "*ESP I*", and the Opinion and Order is hereinafter referred to as the "ESP I Order"); *see also In re Application of Columbus Southern Power Co.*, 128 Ohio St.3d 512, 519 (2011). Thus, and as the Industrial Energy Users-Ohio ("IEU-Ohio") maintains, the accounting that produced the deferred portion of the increase includes amounts that AEP-Ohio may not lawfully collect as part of an ESP. Since a R.C. 4928.144 phase-in may only be authorized by the Commission for amounts lawfully authorized under R.C. 4928.141 to 4928.143, IEU-Ohio is contesting the Commission's refusal to reduce the deferred increase that is eligible for future collection by the amount of the illegally authorized increase (including carrying charges) that resides, for accounting purposes, within the deferred increase. *See* IEU-Ohio Notice of Appeal, Case 2012-0187. IEU-Ohio Appendix at 215-216 (hereinafter referred to as "IEU-Ohio Appx.>").

⁴ *ESP I*, ESP I Order at 22-23 (Mar. 18, 2009) (AEP Appx. at 104-105).

time of the ESP I Order, it was anticipated that the deferred portion of the total increase would ultimately rise to \$600 million dollars.⁵

In the ESP I Order and pursuant to R.C. 4928.144, the Commission identified the amount of the carrying charges to be included on the portion of the total increase that was deferred, through the Commission's phase-in authority, for future collection.⁶ More specifically, the Commission permitted AEP-Ohio to add a carrying charge to the deferred increase at a percentage rate calculated based on a weighted average cost of capital ("WACC") method (approximately 11 percent in this case).⁷ The Commission also permitted AEP-Ohio to accrue carrying charges on deferred amounts without adjusting for accumulated deferred income taxes ("ADIT").⁸

As briefly stated above, the Commission's ESP I Order also made it clear that the Commission would, in the future, determine what portion of the amount deferred during the term of the ESP would be subject to future collection through a non-bypassable charge.⁹ Accordingly,

⁵ Although AEP-Ohio makes much of the fact its parent company infused \$550 million of equity into AEP-Ohio after the Commission issued the ESP I Order, AEP-Ohio later testified that the equity infusion was unrelated to the phase-in. *In the Matter of the Application of Columbus Southern Power Company and Ohio Power Company for Authority to Establish a Standard Service Offer Pursuant to Section 4928.143, Revised Code, in the Form of an Electric Security Plan*, Case Nos. 11-346-EL-SSO, *et al.*, Tr. Vol. II at 470 (IEU-Ohio Supplement at 5) (hereinafter referred to as IEU-Ohio Supp.) AEP-Ohio's second ESP proceeding is hereinafter referred to as "*ESP II*".

⁶ *ESP I*, ESP I Order at 23 (Mar. 18, 2009) (AEP Appx. at 105).

⁷ *Id.*

⁸ *Id.* at 24 (AEP Appx. at 106).

⁹ *ESP I*, ESP I Order at 22-23 (AEP Appx. at 104-105); *In the Matter of the Application of Columbus Southern Power Company for Approval of a Mechanism to Recover Deferred Fuel Costs Ordered Under Section 4928.144, Ohio Revised Code*, Case Nos. 11-4920-EL-RDR, *et al.*, Finding and Order at 2, 18 (Aug. 1, 2012) (AEP Appx. at 10, 26). This proceeding is hereinafter

the ESP I Order made no determination regarding the carrying charge rate that would apply once AEP-Ohio began to collect the deferred portion of the *ESP I* increase through the non-bypassable charge called for by R.C. 4928.144.¹⁰ Instead, the deferred amount, if any, eligible for future recovery from customers and the amount of carrying charges that would be allowed during the post *ESP I* amortization period were subject to the Commission's subsequent determinations. The portion subject to future collection depended on the level of revenue collected by AEP-Ohio during the term of the ESP relative to the amount the Commission could lawfully authorize AEP-Ohio to collect¹¹ and the appropriateness of AEP-Ohio's accounting regarding the phase-in deferral.¹²

B. The Ever-Changing Phase-In

Since its authorization, the Commission has maintained ongoing supervision and jurisdiction over the *ESP I* phase-in, modifying the scope and terms of the phase-in through subsequent decisions and in separate proceedings. In the July 23, 2009 Entry on Rehearing, for example, the Commission determined that certain riders were exempt from the bill increase

referred to as the "*PIRR Case*" and the Finding and Order is hereinafter referred to as the "*PIRR Order*."

¹⁰ Because R.C. 4928.144 requires a phase-in deferral to be recovered through a non-bypassable charge, the collection of the deferred portion of the increase cannot be avoided by shopping customers. Generally speaking, a non-bypassable charge works to reduce a utility's business and financial risk.

¹¹ *ESP I*, ESP I Order at 22 (AEP Appx. at 104). As already noted, the Supreme Court of Ohio subsequently determined that the total increase in the first ESP case was illegally excessive, remanding the unsupported authorization of POLR charges and environmental investment carrying charges. See *In re Application of Columbus Southern Power*, 128 Ohio St.3d 512 (2011); see also *ESP I*, Order on Remand (Oct. 3, 2011).

¹² R.C. 4928.144 requires the Commission to order the creation of a regulatory asset pursuant to general accepted accounting principles (IEU-Ohio Appx. at 490).

limits that determined the portion of the total *ESP I* increase subject to collection during the term of *ESP I*.¹³ This determination effectively reduced the amount of the total increase that was deferred for future collection.

In a Finding and Order, on July 29, 2009, the Commission granted IEU-Ohio's Application for Rehearing and revoked authorization for AEP-Ohio to recover the cost of maintenance of the Waterford and Darby generating facilities.¹⁴ As a result of its ruling regarding the Waterford and Darby generating facilities, the Commission directed AEP-Ohio to credit the deferred portion of the increase by \$22 million.¹⁵

In a separate proceeding, and at AEP-Ohio's request, the Commission further modified the terms of the *ESP I* phase-in by placing the rate increase effects of AEP-Ohio's Economic Development Cost Recovery Rider ("Rider EDR") outside the phase-in related bill increase limits established in the *ESP I* Order.¹⁶ IEU-Ohio appealed the Commission's decision, claiming that the Commission violated the *ESP I* Order.¹⁷ AEP-Ohio and the Commission successfully opposed IEU-Ohio's appeal. More specifically, the Court held that the

¹³ *ESP I*, Entry on Rehearing at 8-9 (Jul. 23, 2009) (AEP Appx. at 168-169). IEU-Ohio objected to the modification, arguing that no rider should be exempt from the bill limits.

¹⁴ *ESP I*, Entry on Rehearing at 2 (Jul. 29, 2009) (IEU-Ohio Appx. at 468).

¹⁵ *Id.* AEP-Ohio subsequently appealed the Commission's determination to the Court; the appeal was denied. *In re Application of Columbus Southern Power Company*, 128 Ohio St.3d 402 (2011).

¹⁶ See *In re Columbus Southern Power Company*, 129 Ohio St.3d 568 (2011) (hereinafter "*EDR Case*"). The modification was required because the *ESP I* Order identified specific riders that were not subject to the phase-in related bill increase limits and Rider EDR was not such a rider. *ESP I*, Entry on Rehearing at 8-9 (Jul. 23, 2009) (AEP Appx. at 168-169).

¹⁷ *EDR Case*, 129 Ohio St.3d 568, 569-570 (2011).

Commission had not ruled out further modifications regarding the *ESP I* decision (including the phase-in) and that the Commission may prospectively modify earlier decisions.¹⁸

In other proceedings, the Commission directed AEP-Ohio to make additional reductions to the deferred portion of the total *ESP I* increase to remedy the significantly excessive earnings caused by the *ESP I* increase,¹⁹ to remedy unlawfully authorized POLR charges,²⁰ and to remedy a portion of AEP-Ohio's defective accounting that significantly overstated the amount of fuel expense that was passed on to customers through the fuel adjustment clause ("FAC").²¹ As AEP-Ohio identified in its Reply Comments in the proceeding below, future FAC proceedings may further alter the deferred balances.²²

C. Remand of *ESP I*

On April 19, 2011, the Court remanded AEP-Ohio's first *ESP*. *In re Application of Columbus Southern Power Company*, 128 Ohio St.3d 512 (2011). The Court determined that the Commission had improperly authorized environmental investment carrying charges and also held that the POLR charge authorized by the Commission was not supported by the record evidence. In the Order on Remand, the Commission rejected AEP-Ohio's attempt to justify the POLR

¹⁸ *Id.*

¹⁹ *In the Matter of the Application of Columbus Southern Power Company and Ohio Power Company for Administration of the Significantly Excessive Earnings Test under Section 4928.143(F), Revised Code, and Rule 4901:1-35-10, Ohio Administrative Code.*, Case No. 10-1261-EL-UNC, Opinion and Order at 36-37 (Jan. 11, 2011) (IEU-Ohio Appx. at 464-465).

²⁰ *ESP I*, Order on Remand at 39 (Oct. 3, 2011) (IEU-Ohio Appx. at 404).

²¹ *In the Matter of the Fuel Adjustment Clauses of Columbus Southern Power Company and Ohio Power Company*, Case Nos. 09-872-EL-FAC, *et al.*, Opinion and Order at 12-13,19 (Jan. 23, 2012) (IEU-Ohio Appx. at 234-235, 241).

²² *PIRR Case*, Reply Comments of AEP-Ohio at 18-19 (Apr. 17, 2012) (IEU-Ohio Supp. at 8-9).

charges based on the same formula-based methodology the Court had previously determined did not reflect the cost of providing POLR service.²³ In contrast to its decision to reject AEP-Ohio's request to continue the POLR charges, the Commission authorized the environmental investment component to remain in rates. In support of this holding, the Commission found that there was sufficient evidence in the record in the 2008 hearings to find that the environmental investment component could be approved under R.C. 4928.143(B)(2)(d).²⁴

Although the Commission has directed AEP-Ohio to reduce the deferred amounts as a result of the outcomes of certain proceedings, the Commission did not direct AEP-Ohio to decrease the deferred amounts for the unlawful POLR and environmental investment component that resulted from the remand of AEP-Ohio's first ESP. The Commission stated that such a reduction to the deferred amounts would constitute unlawful retroactive ratemaking.²⁵

Following the Commission's Order on Remand, IEU-Ohio filed an Application for Rehearing requesting that the Commission reverse its findings on the environmental investment component and the flow-through effects of the remand of the ESP.²⁶ In general, the Commission cited its prior Order on Remand to deny rehearing, but on the issue of the application of flow-through effects, the Commission clarified that it could not order a refund of POLR charges that had previously been collected from customers.²⁷ After the Commission denied the Application

²³ *ESP I*, Order on Remand at 15-34 (IEU-Ohio Appx. at 380-399).

²⁴ *Id.* at 13-14 (IEU-Ohio Appx. at 378-379).

²⁵ *Id.* at 35-36 (IEU-Ohio Appx at 400-401). IEU-Ohio has also contested the Commission's determination in a separate appeal.

²⁶ *ESP I*, Application for Rehearing of Order on Remand and Memorandum in Support of Industrial Energy Users-Ohio (Nov. 2, 2011) (IEU-Ohio Appx. at 333-337).

²⁷ *ESP I*, Entry on Rehearing at 18 (Dec. 14, 2011) (IEU-Ohio Appx. at 260).

for Rehearing, IEU-Ohio filed a Notice of Appeal.²⁸ That proceeding is pending with the Court.²⁹ The resolution of that proceeding, however, may have a dramatic impact on the deferred amounts ultimately subject to collection from customers.

D. AEP-Ohio's Application to Set Terms for the Recovery Period

On September 1, 2011, consistent with the ESP I Order, AEP-Ohio filed a separate application seeking approval to increase rates so as to commence the amortization of the portion of the *ESP I* increase that AEP-Ohio had, from an accounting perspective, deferred.³⁰ This application asked the Commission to permit the amortization process to proceed even though there were and are several open Commission proceedings that will affect the ultimate amount of the *ESP I* increase that is properly recoverable. The Application requested that the Commission authorize AEP-Ohio to accrue interest at a WACC during the Recovery Period. Application at 3. Also, the Application requested that carrying charges accrue on a deferral balance unadjusted for ADIT. *Id.* at 2-3. As discussed further below, the PIRR Order denied the former but granted the latter request.

On August 1, 2012, the Commission, without holding a hearing, modified and approved AEP-Ohio's PIRR Application. Among other things, the PIRR Order determined that due to the decreased risk associated with commencing recovery of the deferred balances through a non-bypassable charge and consistent with regulatory practice and long-standing Commission

²⁸ Notice of Appeal of Appellant Industrial Energy Users-Ohio (Feb. 1, 2012) (IEU-Ohio Appx. at 214-216).

²⁹ IEU-Ohio has summarized its arguments in this appeal, as these issues have been more fully developed and briefed in Supreme Court Case No. 2012-0187.

³⁰ *PIRR Case*, PIRR Application (Sep. 1, 2011) (IEU-Ohio Supp. at 61).

precedent,³¹ AEP-Ohio must accrue carrying charges during the amortization period at AEP-Ohio's long-term debt rate.³² For similar reasons, the Commission directed AEP-Ohio to compound interest annually rather than monthly. The PIRR Order noted that the ESP I Order did not establish carrying charge terms to apply during the Recovery Period and that the ESP I Order "contemplated that the Company would file a separate application to establish a recovery mechanism, which the Company in fact filed in these cases on September 1, 2011, and is presently the subject of our review." PIRR Order at 17-18 (AEP Appx. at 25-26). The PIRR Order also stated that the Commission maintains ongoing jurisdiction over the phase-in and that it had not ruled out modifying the structure and content of the phase-in.³³

The PIRR Order, however, rejected IEU-Ohio's argument that the deferral balance must be reduced to account for the flow-through effects of the remand of AEP-Ohio's ESP.³⁴ And, while the Commission correctly recognized that it would be improper to permit AEP-Ohio to

³¹ *In the Matter of the Application of Columbus Southern Power Company and Ohio Power Company to Adjust Each Company's Transmission Cost Recovery Rider*, Case No. 08-1202-EL-UNC, Finding and Order (Dec. 17, 2008) (IEU-Ohio Appx. at 475-479); *In the Matter of the Application of Columbus Southern Power Company and Ohio Power Company for Authority to Modify Their Accounting Procedure for Certain Storm-Related Services Restoration Costs*, Case No. 08-1301-EL-AAM, Finding and Order (Dec. 19, 2008) (IEU-Ohio Appx. at 470-474); *In the Matter of the Commission Review of the Capacity Charges of Ohio Power Company and Columbus Southern Power Company*, Case No. 10-2929-EL-UNC, Opinion and Order at 23-24 (Jul. 2, 2012) (IEU-Ohio Appx. at 191-192).

³² The effect of using a long term debt rate during the amortization period allows interest to be charged to customers on the deferred balance including the WACC-based interest accumulated in that balance. Thus, the use of a debt-based interest rate during the amortization period works to finance the common equity return embedded in the accumulated deferred balance. AEP-Ohio's long term debt rate is the embedded long term debt rate which is significantly above a reasonable current long term debt rate. Thus, even the use of a long term debt rate in this circumstance leads to significantly overstated financing costs.

³³ *PIRR Case*, PIRR Order at 18 (AEP Appx. at 26).

³⁴ *PIRR Case*, PIRR Order at 20 (AEP Appx. at 28).

collect excessive carrying charges during the Recovery Period, the Commission failed to require AEP-Ohio to accrue carrying charges on a deferred balance reduced by ADIT. The PIRR Order stated that the Commission had not been persuaded to make the ADIT adjustment and that allowing AEP-Ohio to accrue carrying charges without reflecting tax effects would be “inconsistent with prior Commission precedent or sound regulatory practice.” PIRR Order at 19 (AEP Appx. at 27). One week after the PIRR Order, however, the Commission, in the Opinion and Order approving AEP-Ohio’s second ESP, held that AEP-Ohio must reflect the tax benefit of ADIT in the Distribution Investment Rider, stating, “it is not appropriate to establish the DIR rate mechanism in a manner which provides the Company with the benefit of ratepayer supplied funds. Any benefits resulting from ADIT should be reflected in the DIR revenue requirement.” *ESP II* Order at 47 (IEU-Ohio Appx. at 132). Because the PIRR Order failed to direct AEP-Ohio to make a similar ADIT adjustment to the deferral balance upon which carrying charges accrue, AEP-Ohio has been authorized to accrue carrying charges on overstated balances. As a consequence of this decision, customers will be overcharged.

IEU-Ohio, the Office of the Ohio Consumers’ Counsel (“OCC”), and AEP-Ohio each took appeals from the PIRR Order. Additionally, East Ohio Gas (“Dominion”) filed an Amicus Brief in support of AEP-Ohio’s appeal, alleging that it is related to its own appeal in Case 2012-2117.³⁵

III. STANDARD OF REVIEW

³⁵ Dominion’s appeal is largely based upon a claim that the Commission “unlawfully altered the legal significance of DEO’s past conduct and deprived DEO of due process” in violation of the Ohio Constitution. As discussed further in Section IV.A.5, AEP-Ohio has not raised such an argument in its application for rehearing or its appeal; thus, all but pages 16 through 18 of Dominion’s Amicus Brief are irrelevant to the issues presented in AEP-Ohio’s appeal.

R.C. 4903.13 states that “[a] final order made by the public utilities commission shall be reversed, vacated, or modified by the supreme court on appeal, if, upon consideration of the record, such court is of the opinion that such order was unlawful or unreasonable.” With regard to the Commission’s determinations regarding questions of fact, the Court has held that it “will not reverse or modify a [commission] decision as to questions of fact where the record contains sufficient probative evidence to show that the determination is not manifestly against the weight of the evidence and is not so clearly unsupported by the record as to show misapprehension, mistake, or willful disregard of duty.”³⁶ The appellant “bears the burden of demonstrating that the commission’s decision is against the manifest weight of the evidence or is clearly unsupported by the record.”³⁷

As to matters of law, the Court has “complete and independent power of review” in appeals from the Commission.³⁸ But, the Court has deferred to the Commission with respect to interpretations of law: “due deference should be given to the statutory interpretations made by an agency that has substantial expertise and to which the General Assembly has delegated enforcement responsibility.”³⁹

IV. LAW AND ARGUMENT

A. IEU-OHIO’S RESPONSE TO AEP-OHIO’S PROPOSITIONS OF LAW A AND B

³⁶ *The Cincinnati Gas & Elec. Co. v. Pub. Util. Comm.*, 86 Ohio St.3d 53, 58, 711 N.E.2d 670 (1999).

³⁷ *Constellation NewEnergy v. Pub. Util. Comm.*, 104 Ohio St.3d 530, 2004-Ohio-6767 at ¶50.

³⁸ *Ohio Edison Co. v. Pub. Util. Comm.*, 78 Ohio St.3d 466, 469, 678 N.E.2d 922 (1997).

³⁹ *Payphone Association v. Pub. Util. Comm.*, 109 Ohio St.3d 453, 462 (2006) (citing *Weiss v. Pub. Util. Comm.*, 90 Ohio St.3d 15, 17-18 (2000)).

1. The PIRR Order did not modify a fact previously adjudicated in the ESP I Order.

AEP-Ohio has raised four legal arguments in its appeal, each of which is based upon the premise that the PIRR Order modified a fact previously adjudicated in the ESP I Order.

According to AEP-Ohio:

1. The Commission modified a previously adjudicated fact and the Commission cannot prospectively modify earlier orders;⁴⁰
2. *Res judicata* bars relitigation of the carrying charge terms that were determined in the ESP I Order;⁴¹
3. The regulatory precedent relied upon by the Commission does not support the finding that the Commission can make changes or modifications to the ESP I Order;⁴²
4. The Commission's retroactive modification of the terms of the expired ESP denied AEP-Ohio the ability to exercise its right to withdraw from the ESP.⁴³

Each of AEP-Ohio's claims is based upon the assertion that the Commission conclusively determined in the ESP I Order the carrying charge terms to be applied in both the Deferral Period and the Recovery Period. Because AEP-Ohio's foundational factual assertion is unsupported (and was rejected by the Commission), the Court must reject each of AEP-Ohio's claims.

The ESP I Order provided AEP-Ohio accounting authority to defer amounts that exceeded certain bill limits during the ESP period, with carrying charges. But, the ESP I Order did not determine what portion of the deferred amounts would ultimately be subject to collection

⁴⁰ AEP-Ohio Merit Brief at 8-13.

⁴¹ *Id.* at 13-15.

⁴² *Id.* at 15-17.

⁴³ *Id.* at 21-23.

or the carrying charge terms to be applied during the Recovery Period.⁴⁴ As AEP-Ohio identified, the ESP I Order required AEP-Ohio to file a separate application and receive approval from the Commission prior to establishing a recovery mechanism.⁴⁵ As contemplated in the ESP I Order, the Commission established the carrying charge terms for the Recovery Period in the PIRR Order.⁴⁶

In support of its claim that the ESP I Order set the carrying charge terms to apply during the Recovery Period, AEP-Ohio claims that the Commission conceded in the PIRR Order that it was modifying its prior ESP I Order determination.⁴⁷ This is simply not true. The PIRR Order noted that the ESP I Order had generally approved the terms of the phase-in to apply during the Deferral Period, but the ESP I Order had fully intended that the terms of the Recovery Period would be established under a separate application:

Although the Commission generally approved AEP-Ohio's proposed phase-in plan and authorized recovery of its deferred fuel expenses in the ESP I Order, *the order also contemplated that the Company would file a separate application to establish a recovery mechanism, which the Company in fact filed in these cases on September 1, 2011, and is presently the subject of our review.*⁴⁸

The PIRR Order's reference to a modification of the ESP I Order merely refers to the fact that the Commission departed from the methodology of accruing carrying charges that it authorized AEP-Ohio to utilize during the Deferral Period.

⁴⁴ See *ESP I*, ESP I Order at 19-23 (AEP Appx. at 101-105).

⁴⁵ *PIRR Case*, AEP-Ohio Application for Rehearing at 3 (AEP Appx. at 58).

⁴⁶ *PIRR Case*, PIRR Order at 2, 18 (AEP Appx. at 10, 26).

⁴⁷ AEP-Ohio Merit Brief at 6-7.

⁴⁸ *PIRR Case*, PIRR Order at 18 (emphasis added) (AEP Appx. at 26).

AEP-Ohio also argues that the now-rejected Opinion and Order from AEP-Ohio's second ESP shows that the Commission modified the ESP I Order. In that proceeding, the Commission was focused on the reasonableness of a stipulation, which recommended that AEP-Ohio accrue carrying charges on the deferral balance during the Recovery Period at a long-term debt carrying charge rate.⁴⁹ AEP-Ohio had argued that a long-term debt rate added value to the stipulation because the Commission had previously determined that the higher WACC rate was a reasonable carrying charge method.⁵⁰ In contrast, IEU-Ohio had argued that a 3.1% carrying charge rate, the current market debt interest rate, was more appropriate.⁵¹ The Stipulation was subsequently rejected and cannot be relied upon by AEP-Ohio in this proceeding.

Accordingly, the ESP I Order did not establish carrying charges terms to apply during the Recovery Period. Because AEP-Ohio's appeal is based upon the incorrect assertion that the PIRR Order modified a prior order, the Court should deny AEP-Ohio's appeal.

2. Even assuming the PIRR Order modified a prior order, the Commission properly justified the prospective modification.

Even assuming *arguendo* that the PIRR Order did, in fact, modify the ESP I Order, the Commission may prospectively modify its orders so long as it justifies the change and the change is otherwise lawful. The Court should affirm its prior precedent and deny AEP-Ohio's claim.

AEP-Ohio concedes that the Commission may prospectively modify prior orders. But AEP-Ohio claims that the Commission's authority to modify prior orders is limited to the

⁴⁹ *ESP II*, Opinion and Order at 57-58 (vacated on rehearing) (IEU-Ohio Appx. at 321-322).

⁵⁰ *Id.* at 58 (IEU-Ohio Appx. at 322).

⁵¹ *ESP II*, Opinion and Order at 58. (Dec. 14, 2011) (vacated on rehearing) (IEU-Ohio Appx. at 322).

“authority to change its position on policy issues that are applied to the industry, but not as to adjudicated facts it reaches on specific cases for specific utilities in its judicial role.”⁵² AEP-Ohio’s understanding of the Commission’s ability to modify prior orders is founded nearly entirely on *Cleveland Elec. Illum. Co. v. Pub. Util.*, 42 Ohio St. 2d 403 (1975).

A closer examination of the law and facts contained in *Cleveland Electric* shows that AEP-Ohio’s understanding of the law is incorrect and that *Cleveland Electric* is not applicable to the facts in this case. In *Cleveland Electric*, the Court was critical of the Commission in two respects: (1) The Commission reversed sixty-year old precedent—stemming from cases in 1918 and 1947—regarding land that may be included as part of the rate base; and (2) the Commission issued an inconsistent decision regarding a utility’s capital structure shortly after the Commission issued its Opinion and Order. Contrary to AEP-Ohio’s claim, *Cleveland Electric* does not stand for the proposition that the Commission can only change its policy position rather than factual findings—rather, the case stands for the proposition that the Commission should be consistent in its orders and not disturb long-standing precedent.⁵³ The PIRR Order did not violate any of these principles.

The PIRR Order did not violate long-standing precedent; the PIRR directed AEP-Ohio to collect the deferred balance consistent with precedent: a host of cases demonstrate that it is appropriate to accrue carrying charges on a deferred balance at a long-term debt rate, especially during a recovery period. If the Commission was inconsistent in any part of the PIRR Order, it

⁵² AEP-Ohio Merit Brief at 9.

⁵³ The Court, stated, “It has been held in this state that ‘administrative interpretation of a given law, while not conclusive, is, *if long continued*, to be reckoned with most seriously and is not to be disregarded and set aside unless judicial construction makes it imperative to do so.’” *Cleveland Electric Illum.*, 42 Ohio St.2d 403, 431 (*quoting Indust. Comm. v. Brown*, 92 Ohio St. 309, 311) (emphasis added).

was not in the manner that AEP-Ohio claims. Rather, the Commission should be criticized for the portion of the PIRR Order related to ADIT (discussed supra at Section IV.B.1).

Cleveland Electric did not address the Commission's authority to prospectively modify its orders when such orders do not involve long-standing precedent. The Court has consistently rejected the notion that prior Commission orders cannot be modified prospectively, so long as the Commission properly justifies its modification.

Indeed, the Court has already upheld a modification of the terms of the phase-in that is the subject of this appeal. *In re Columbus Southern Power Company*, 129 Ohio St.3d 568, 569-570 (2011) (the *EDR Case*). In a case of role reversal, IEU-Ohio appealed the Commission's determination to modify the phase-in to allow AEP-Ohio to collect the economic development rider outside of the bill limits established in the ESP I Order. In the section of the *EDR Case* decision titled "IEU Has Not Shown that the Commission Erred in Modifying the Phase-in of AEP's Rates," the Court denied IEU-Ohio's appeal, stating that the Commission did not rule out further modifications of the phase-in and the Commission may prospectively modify earlier orders:

[T]he order below did not violate the earlier, electric-security-plan order. It is true, as IEU argues, that the earlier order did not exempt the rider from the rate-increase limits. ***But the commission did not rule out further exemptions, and as a general rule, the commission has discretion to revisit earlier regulatory decisions and modify them prospectively.***⁵⁴

As is clear by the *EDR Case*, the Commission can and has modified previously adjudicated determinations and prospectively applied such determinations to the same utility.

⁵⁴ *In re Application of Columbus Southern Power Co.*, 129 Ohio St.3d 568, 569 (2011) (emphasis added).

The case at bar is no different than the *EDR Case*. Although the Commission authorized AEP-Ohio to accrue carrying charges at a WACC rate during the Deferral Period, the Commission did not rule out modifying the terms of the phase-in. Moreover, the Commission has an ongoing duty to ensure that the phase-in is just and reasonable. *See* R.C. 4928.144. As circumstances require, the Commission must prospectively modify the phase-in to ensure that it is just and reasonable.

A legion of cases further supports the Commission's authority to modify prior orders so long as it justifies the change and the result is otherwise reasonable and lawful. In *Office of the Ohio Consumers' Counsel v. Pub. Util. Comm.*, 114 Ohio St. 3d 340, 343 (2007), the Court rejected OCC's argument that it was unlawful for the Commission to modify aspects of its previous order. The Court held that the Commission can revisit previous orders so long as it justifies its modification:

OCC's argument that the commission erred in changing certain provisions of its previous order is without merit. The commission may change or modify earlier orders as long as it justifies any changes. *Consumers' Counsel v. Pub. Util. Comm.* (1984), 10 Ohio St.3d 49, 50-51, 10 OBR 312, 461 N.E.2d 303. The commission found that several important projections relied on by the MDP-extension stipulation had not in fact materialized and that that circumstance justified some modifications to its earlier order. The commission found that the competitive market in DP&L's service territory had not developed as the commission had expected when it approved the MDP-extension stipulation. According to testimony at the hearing, only 0.03 percent of DP&L's total load (representing seven small-business customers) had switched to a retail electric service provider not affiliated with DP&L

As a result, the commission determined that the stipulation in this case would benefit ratepayers and the public interest by protecting DP&L's standard-service customers from price volatility and rate shock ***In sum, the record supports the changes, and the commission explained its reasons for modifying its earlier order approving the MDP-extension stipulation.*** See

Ohio Consumers' Counsel v. Pub. Util. Comm., 110 Ohio St.3d 394, 2006-Ohio-4706, 853 N.E.2d 1153, at ¶ 25.⁵⁵

In *Ohio Consumers' Counsel v. Pub. Util. Comm.*, 110 Ohio St.3d 394 (2006), several parties entered into a stipulation to modify the manner in which the Dayton Power & Light Company collected billing-related costs. More specifically, the parties sought to modify a prior order that provided "DP&L could not recover its billing-related costs from CRES providers before 2007." *Id.* at ¶ 25. OCC challenged the proposed modification, claiming that a prior order had conclusively decided issues pertaining to billing-related cost recovery and that the order could not be modified. The Court rejected OCC's argument, stating that "the PUCO may change or modify earlier orders as long as it justifies any changes." *Id.*; see also *In re Application of Columbus Southern Power Co.*, 128 Ohio St.3d 512 at ¶ 52 (2011). These cases provide ample authority to affirm the alleged modification by the Commission in the proceeding below.

The Court should give no weight to AEP-Ohio's claim that the Commission has attempted to create a world where "factual decisions relied upon by a utility to carry out a Commission order (regardless of whether they were made last week, last year or relied upon for years before) have no certainty because the Commission is allowed to simply change its mind at any time." AEP-Ohio Merit Brief at 2. The Court has held that the Commission cannot simply change its mind; the Commission must justify its change. *Office of Ohio Consumers' Counsel v. Pub. Util. Comm.*, 10 Ohio St.3d 49 (1984) ("In the case *sub judice* the commission has failed to justify its apparent decision to cut short its previously ordered four-year phase-in period."). The Commission properly justified the change in the case below.

⁵⁵ *Ohio Consumers Counsel v. Pub. Util. Comm.*, 114 Ohio St.3d 340 at ¶ 14 (2007) (emphasis added).

The PIRR Order provided not one but three acceptable reasons for its change. First, the Commission determined that the lingering economic recession justified requiring AEP-Ohio to accrue carrying charges on the deferred balance at a long-term debt rate during the Recovery Period. AEP-Ohio purports that the recession is not a proper justification for the change because it existed at the time the deferral was authorized. AEP-Ohio Merit Brief at 15-16. But AEP-Ohio ignores the fact that four years have passed since the ESP I Order and the effects of the recession remain. The existence of the recession during the Recovery Period has great significance—customers will feel the impact of the recession as well as the increased burden of the non-bypassable rider. There is no evidence to support the conclusion that the ESP I Order contemplated that the economic recession would linger and bleed into the Recovery Period. *See Ohio Consumers Counsel v. Pub. Util. Comm.*, 114 Ohio St.3d 340 (2007) (“The commission found that several important projections relied on by the MDP-extension stipulation had not in fact materialized and that circumstance justified some modifications to its earlier order.”). Thus, the fact that AEP-Ohio has commenced collection of the deferred amounts before the recession has ended justifies the change.

Second, the Commission determined that once collection of the deferral commences through a non-bypassable charge, the decreased risk of non-collection justifies lowering the carrying charge rate. AEP-Ohio failed to address this justification in either its Merit Brief or its application for rehearing.

Third, the Commission determined that precedent and regulatory practice support the Commission’s decision.⁵⁶ AEP-Ohio claims that the Commission distinguished this precedent in

⁵⁶ *In the Matter of the Application of Columbus Southern Power Company and Ohio Power Company to Adjust Each Company's Transmission Cost Recovery Rider*, Case No. 08-1202-EL-UNC, Finding and Order (Dec. 17, 2008) (hereinafter “TCRR Case”) (IEU-Ohio Appx. at 475-

the ESP I Order. Although the ESP I Order distinguished two of the three cases that were cited in the PIRR Order, the Commission distinguished these cases for a different reason. The ESP I Order distinguished the *TCRR Case* and *Storm Case* because those cases involved short-term deferral periods, and the ESP I Order held that it would be more appropriate to allow AEP-Ohio to accrue carrying charges at a WACC during the longer deferral period: “we believe that, with regard to the equity component, these cases are distinguishable from the current ESP proceeding, where we are establishing the standard service offer and *requiring the Company to defer the collection of incurred generation costs associated with fuel over a longer period.*”⁵⁷ The Commission did not determine that a WACC rate would be appropriate *after* the Deferral Period ended.

The third case (the “*Capacity Case*”) referenced in the PIRR Order contains a similar fact pattern to the case below. *Capacity Case* at 23-24 (IEU-Ohio Appx at 191-192). The Commission authorized AEP-Ohio to accrue carrying charges at a WACC rate but required AEP-Ohio to accrue carrying charges at a long-term debt rate after a recovery mechanism was approved in a separate case. *Id.* The holding in the *Capacity Case* is directly on point, and AEP-Ohio has failed to attempt to distinguish it. Thus, the *Capacity Case*—which is most closely aligned to the facts in this case—supports the Commission’s determination.

3. *Res Judicata* does not Bar the Commission from directing AEP-Ohio to accrue carrying charges at a long-term debt rate.

480); *In the Matter of the Application of Columbus Southern Power Company and Ohio Power Company for Authority to Modify Their Accounting Procedure for Certain Storm-Related Services Restoration Costs*, Case No. 08-1301-EL-AAM, Finding and Order (Dec. 19, 2008) (hereinafter “*Storm Case*”) (IEU-Ohio Appx. at 470-474); *In the Matter of the Commission Review of the Capacity Charges of Ohio Power Company and Columbus Southern Power Company*, Case No. 10-2929-EL-UNC, Opinion and Order at 23-24 (July 2, 2012) (hereinafter “*Capacity Case*”) (IEU-Ohio Appx. at 191-192).

⁵⁷ *ESP I*, ESP I Order at 23, fn 9 (AEP Appx. at 105) (emphasis added).

AEP-Ohio's argument that principles of *res judicata* require reversal is largely a reiteration of its claim that the Commission cannot modify its prior orders. AEP-Ohio's only added layer is its citation to *Office of Ohio Consumers' Counsel v. Pub. Comm.*, 16 Ohio St.3d 9, 10 (1985). In that case, OCC appealed a Commission determination of a utility's fuel procurement practices. The Court determined that the Commission, in a prior case, had already determined that the utility's fuel procurement practices were proper during the very period under scrutiny. Because the Commission had not deferred the issue to a subsequent proceeding, OCC was barred from raising the issue in its appeal. *Id.* at 10. The facts in this case are distinguishable for several reasons.

Res judicata precludes the "relitigation of a point of law or fact that was at issue in a former action between the same parties and was passed upon by a court of competent jurisdiction."⁵⁸ It requires "an identity of parties and issues in the proceedings."⁵⁹

Res judicata simply does not apply in this circumstance because the ESP I Order did not address the carrying charge rate to be applied during the Recovery Period or the amount of the deferred balances that would be eligible for recovery. As AEP-Ohio concedes, it was required to submit an application for approval to amortize the deferred balances and to obtain a Commission determination on the amount of the deferred balance eligible for recovery from customers.⁶⁰ Thus, the issues in the ESP I Order were not the same as the PIRR Application.

⁵⁸ *State, ex rel. B.O.C. Group, General Motors Corp., v. Indus. Comm.*, 58 Ohio St.3d 199, 200-201 (1991).

⁵⁹ *Id.*

⁶⁰ *PIRR Case*, AEP-Ohio Application for Rehearing at 3 (emphasis added) (AEP Appx. at 58).

Moreover, the Commission did not rule out making further modifications to the phase-in. *See EDR Case.*⁶¹ Indeed, the Commission has exercised ongoing jurisdiction over the terms of the phase-in and repeatedly issued decisions altering the deferral balance. The Commission must ensure that the phase-in is just and reasonable, and the Court has deferred to the Commission's ongoing supervision of the phase-in.⁶² The Court has determined that principles of *res judicata* have no application to separate periods of time, if a regulatory body maintains ongoing jurisdiction: "At issue in the case at bar is a separate assessment based on an entirely different audit period, and we find that the requisite identity of issues is not present." *Ex. rel. B.O.C. Group v. Indust. Comm.*, 58 Ohio St.3d 199, 201 (1991). Because the PIRR Order relates to an aspect of the phase-in that relates to a separate, prospective time period, principles of *res judicata* do not apply. *Id.*

4. The PIRR Order did not violate R.C. 4928.143(C)(2) and the Commission is not estopped from altering the rate at which AEP-Ohio accrues carrying charges on the deferred balance during the Recovery Period.

Finally, AEP-Ohio claims that the Commission is "estopped by R.C. 4928.143 from unilaterally modifying a provision of *ESP I* due to the Company's statutory right to withdraw from the ESP based on Commission modifications." AEP-Ohio Merit Brief at 21. AEP-Ohio claims that an ESP is a voluntary plan and that AEP-Ohio cannot exercise its right to withdraw because the Commission modified the ESP after it had already terminated. *Id.* AEP-Ohio's claim is meritless.

First, as stated above, the Commission did not modify the ESP I Order because that order did not determine the carrying charge rate to be applied to the deferred balance during the

⁶¹ *EDR Case*, 129 Ohio St.3d 568, 569 (2011).

⁶² *Id.* at 570; *see also* R.C. 4928.144.

amortization period or the deferred amount subject to amortization through a phase-in mechanism. Moreover, as a practical matter, the ESP I Order contemplated that the PIRR Application would be filed at the end of the ESP; thus, the order approving or modifying and approving the PIRR Application could not have occurred at a time when AEP-Ohio's right to withdraw still existed.

Second, AEP-Ohio cites to no precedent to support its position.

Third, AEP-Ohio's *estoppel* position is disingenuous. AEP-Ohio's view of R.C. 4928.141(C)(1) (as demonstrated in AEP-Ohio's ESP tariff submission letter), is that the electric distribution utility never has to say "yes" to the Commission's version of a modified ESP, but can say "no" and withdraw from an ESP at any time.⁶³ If AEP-Ohio is not estopped from rejecting a modified ESP after it receives the benefit of rate increases, then the Commission should not be estopped from altering the phase-in.

Fourth, AEP-Ohio has not claimed that it would have exercised its right to withdraw from the ESP based on the PIRR Order's directive that AEP-Ohio accrue carrying charges at a debt rate. Therefore, even if the Commission violated AEP-Ohio's right to withdraw from the ESP, AEP-Ohio has failed to demonstrate prejudice from the Commission's action. *Meyers v. Pub. Util. Comm.*, 64 Ohio St.3d 299, 302-304 (1992); *In re Application of Columbus S. Power Co.*, 134 Ohio St.3d 392 at ¶ 45-46 (2012).

5. Dominion's Amicus Brief addresses issues that are not relevant to this appeal

⁶³ In *In the Matter of the Application of Columbus Southern Power Company for Approval of an Electric Security Plan; an Amendment to its Corporate Separation Plan; and the Sale or Transfer of Certain Generating Assets*, Case Nos. 11-346-EL-SSO, et al., Letter of Steven T. Nourse to Greta See at 2 (Aug. 16, 2012) (IEU-Ohio Supp. at 2).

Dominion alleges that the resolution of this proceeding impacts its rights in a separate appeal. That appeal is largely based upon a claim that the Commission “unlawfully altered the legal significance of DEO’s past conduct and deprived DEO of due process” in violation of the Ohio Constitution. Pages one through fifteen of Dominion’s Amicus Brief are dedicated to this legal argument. But, AEP-Ohio’s application for rehearing and AEP-Ohio’s appeal do not claim that the PIRR Order violated the Ohio Constitution or that the Commission retroactively applied laws to past conduct. Because AEP-Ohio and Dominion have not raised this legal argument in an application for rehearing in the proceeding below, this issue is not properly before the Court in this appeal. *EDR Case*, 129 Ohio St.3d 568, 571 (2011) (holding that arguments not raised in an application for rehearing are forfeited).

The remaining two full pages of Dominion’s Amicus Brief (16-18) claim that the Commission does not have “authority to apply new standards to past conduct.” Dominion Amicus Brief at 1. Dominion then goes on to assert that even if the Commission may modify prior orders, the modification cannot apply retroactively. Dominion Amicus Brief at 17. First, the PIRR Order did not modify a prior order. Second, even if the Commission did modify the ESP I Order the PIRR Order did not retroactively direct AEP-Ohio to accrue carrying charges at a long-term debt rate. The Commission specifically stated that AEP-Ohio may continue to accrue carrying charges at a WACC until the Recovery Period. PIRR Order at 18 (AEP Appx. at 26). Thus, the modification is prospective.

6. Summary of IEU-Ohio’s Response to AEP-Ohio’s Appeal

AEP-Ohio’s appeal asserts several reasons why the PIRR Order unlawfully and unreasonably modified a prior Commission order. Because the PIRR Order did not modify a prior order, AEP-Ohio’s appeal must be denied.

Even if the Commission did modify its prior order, the Commission has authority to modify prior orders so long as it justifies the change and the result is otherwise lawful. In the case at bar, the Commission has justified requiring AEP-Ohio to accrue carrying charges at a long-term debt rate during the Recovery Period. Regulatory practices and principles, decreased risk of non-collection associated with a non-bypassable charge, as well as the lingering economic recession provide requisite support for the Commission's directive. Therefore, the PIRR Order's directive that AEP-Ohio accrue carrying charges at a long-term debt rate on an annual basis should be upheld.

B. IEU-OHIO'S CROSS-APPEAL

- 1. The Commission's Finding and Order is unlawful and unreasonable because the Commission failed to require AEP-Ohio to calculate carrying charges on deferred balances adjusted for accumulated deferred income taxes; the Commission's failure to adjust the deferred balances for ADIT violated generally accepted accounting principles, state policy, sound regulatory practices and principles, and precedent**

The PIRR Order authorized AEP-Ohio to accrue carrying charges on overstated deferral balances that did not reflect a reduction for ADIT, which represents cost free capital. The PIRR Order and Fifth Entry on Rehearing provided three rationales to authorize AEP-Ohio to accrue carrying charges on cost free capital: (1) "carrying charges on the deferral should be calculated without an adjustment for ADIT in order to ensure that AEP-Ohio recovers its actual fuel expenses,"⁶⁴ (2) R.C. 4928.144 "makes no mention of an adjustment to account for tax effects,"⁶⁵ and (3) "the Commission believes that the question of whether ADIT should be reflected in the calculation of carrying charges to be included in the PIRR is a matter separate and apart from

⁶⁴ *PIRR Case*, Entry on Rehearing at 8 (Oct. 3, 2012) (AEP Appx. at 43).

⁶⁵ *Id.*

how AEP-Ohio maintains its books pursuant to GAAP.”⁶⁶ Each of these reasons lacks merit and the result is unlawful and unreasonable.

Pursuant to R.C. 4928.144, the Commission must ensure that the PIRR is just and reasonable, and the amounts deferred for collection through the PIRR comply with generally accepted accounting principles. The Commission’s jurisdiction and supervision over the phase-in is ongoing.⁶⁷ Moreover, in ensuring that the PIRR is just and reasonable, the Commission must follow the policy and statutory requirements set forth under R.C. 4928.⁶⁸

ADIT reflects cost free capital that is available to AEP-Ohio due to the timing difference between book and tax accounting. For tax purposes, AEP-Ohio deducts certain expenses (including amounts that will be deferred for book accounting), but, for book purposes, AEP-Ohio deducts only the portion of its expenses that are not deferred. The timing difference allows AEP-Ohio to recognize an immediate savings on the amount of federal income tax it pays. The income tax savings increases the capital that is available to AEP-Ohio, causing AEP-Ohio to have more internally generated capital available to fund the expenditure that is the subject of the deferral balance. Thus, AEP-Ohio is not financing 100% of the deferral.

Because ADIT represents a source of cost free capital to AEP-Ohio, the Commission permitted AEP-Ohio to accrue carrying charges on overstated deferred balances that included

⁶⁶ *Id.*

⁶⁷ *PIRR Case*, PIRR Order at 17-18 (AEP Appx. at 25-26); see *EDR Case*, 129 Ohio St.3d 568, 569-70 (2011).

⁶⁸ R.C. 4928.02 states that it is the policy of this state to ensure the availability of reasonably priced electric service, and promote customer choice and competition. IEU-Ohio Appx. at 481. R.C. 4928.06(A) requires the Commission to ensure that the policy goals enumerated in R.C. 4928.02 are effectuated. IEU-Ohio Appx. at 483. Thus, the Commission must ensure that its actions and orders further the state policy goals enumerated in R.C. 4928.02.

capital that was not provided by investors or creditors—effectively, AEP-Ohio has been authorized to accrue carrying charges on free money. As discussed further below, the Commission’s determination violated common sense, state policy, regulatory practices and principles, precedent, and generally accepted accounting principles (“GAAP”).

The purpose of carrying charges is to compensate a utility for the cost of borrowing capital from creditors or raising capital from shareholders to fund expenditures. Sound regulatory practices and principles prohibit the recovery of carrying charges on cost-free capital such as ADIT. As the audit report of AEP-Ohio’s 2010 FAC identified:

If the ADIT balance related to the Company’s FAC under-recovery balances is not considered, or deducted somewhere else, such as in rate base, ratepayers would be over-paying carrying costs by paying for carrying costs on the portion of the Deferred Fuel balance that has been financed by tax savings, *i.e.*, on the portion not financed with investor-supplied capital.⁶⁹

Comments filed by the Commission Staff agreed that interest should not apply to ADIT because there is no carrying cost associated with ADIT:

There is no carrying cost associated with the ADIT. The ADIT thus represents a cost-free source of funding for the deferred fuel balance that is provided by ratepayers and not investors. Therefore, it is the Staff’s position that ADIT should have been used by the Companies as a free source of funds.⁷⁰

Common sense dictates that when capital is provided from a source other than creditors or shareholders, carrying charges should not accrue on that capital. This basic tenet should have

⁶⁹ *PIRR Case*, Comments of the Ohio Energy Group (containing an excerpt from the audit of AEP-Ohio’s 2010 FAC Case) (IEU-Ohio Supp. at 58). *See also ESP II*, IEU-Ohio Ex. 129 (Testimony of Joseph Bowser) at 15-16 (IEU-Ohio Appx. at 53-54).

⁷⁰ *PIRR Case*, Revised Comments and Recommendations Submitted on Behalf of the Staff of the Public Utilities Commission of Ohio at 7-8 (IEU-Ohio Supp. at 14-15).

been followed by the Commission in the proceeding below; it was not. Indeed, AEP-Ohio has conceded in other jurisdictions that it is appropriate to reflect ADIT as a reduction to rates.⁷¹

A simple example demonstrates how ADIT provides cost free financing that should not accrue carrying charges.⁷² If AEP-Ohio's expenses were \$200 but the rate cap was \$100, AEP-Ohio would book \$100 for purposes of book accounting, and defer the remaining \$100.⁷³ Yet, AEP-Ohio would be able to deduct \$200 for tax purposes. Because AEP-Ohio can benefit from an immediate deduction without concurrently recognizing the total amount of expense on its books, there is an ADIT benefit equal to the \$100 difference between the "book" and the "tax" expense, multiplied by the tax rate. Assuming a 35% tax rate, AEP-Ohio would reduce its federal income tax liability by \$35. Because AEP-Ohio received \$35 through the tax benefit, AEP-Ohio is able to finance \$100 of the deferral with only \$65 of either debt, equity, or a combination of both.⁷⁴

Because ADIT provides cost free capital that AEP-Ohio need not finance through debt or equity, in the example above, it would only be lawful to authorize AEP-Ohio to calculate carrying charges on a deferral balance of \$65—the remainder was financed by ADIT. To authorize AEP-Ohio to calculate carrying charges without an adjustment for ADIT would allow

⁷¹ AEP-Ohio has testified in states that utilize traditional cost of service ratemaking that it would be appropriate to calculate carrying charges on a deferred balance adjusted for ADIT. Comments of the Ohio Energy Group (containing an excerpted portion of the testimony of AEP witness Mitchell in a West Virginia proceeding, recommending that carrying charges be calculated on a deferral balance adjusted for ADIT) (IEU-Ohio Supp. at 53-54).

⁷² *PIRR Case*, Comments of Industrial Energy Users-Ohio at 11-12 (IEU-Ohio Supp. at 31-32); see *PIRR Case*, IEU-Ohio Application for Rehearing at 11-12 (IEU-Ohio Appx. at 21-22).

⁷³ *Id.*; see also *ESP II*, IEU-Ohio Ex. 129 (Testimony of Joseph Bowser) at 15-16 (IEU-Ohio Appx. at 53-54).

⁷⁴ *PIRR Case*, Comments of Industrial Energy Users-Ohio at 11-12 (IEU-Ohio Supp. at 31-32); see *PIRR Case*, IEU-Ohio Application for Rehearing at 11-12 (IEU-Ohio Appx. at 53-54).

AEP-Ohio to accrue carrying charges on an overstated balance and require customers to overcompensate AEP-Ohio for capital that was not financed.

The primary reason for the PIRR Order's rejection of an ADIT adjustment was the claim that such an adjustment would cause AEP-Ohio to not recover all of its deferred expense:

[C]arrying charges on the deferrals should be calculated without an adjustment for ADIT in order to ensure that AEP-Ohio recovers its actual fuel expenses, as required by Section 4928.144, Revised Code . . . ⁷⁵

The Commission's claim that an ADIT adjustment will somehow prevent AEP-Ohio from collecting its actual expenses is simply wrong. Calculating carrying charges on deferred balances adjusted for ADIT does not prevent AEP-Ohio from recovering each dollar that was expensed.⁷⁶ An adjustment for ADIT does not reduce the principle deferral amount that is subject to potential future collection—it merely reduces the balance upon which AEP-Ohio may accrue carrying charges.⁷⁷ The ADIT adjustment is intended to ensure that carrying charges are accrued only on dollars that were financed and upon which AEP-Ohio will incur interest costs. Otherwise, carrying charges will be accrued on overstated balances and AEP-Ohio will be overcompensated. As discussed below, the Commission's Order confuses ADIT with the regulatory concept that the equity portion of the carrying cost charge must be "grossed up" to ensure the utility recovers all of its costs.⁷⁸

AEP-Ohio finances expenses through debt and equity. The cost of debt (debt interest) is tax deductible. The cost of equity, however, is not tax deductible. Accordingly, the equity

⁷⁵ *PIRR Case*, PIRR Order at 19 (AEP Appx. at 27).

⁷⁶ *PIRR Case*, IEU-Ohio Application for Rehearing at 12-14 (IEU-Ohio Appx. at 22-24).

⁷⁷ *Id.*

⁷⁸ *Id.*

component of the carrying cost charge must be “grossed up” in order for AEP-Ohio to recover its cost of equity. Because the cost of equity capital cannot be used to reduce the federal income tax liability, if the Commission does not “gross up” the equity portion, AEP-Ohio would not be permitted to recover its equity cost. For example, if a tax rate is assumed to be 35%, the gross up factor for the equity component of the carrying charge rate is 1/.65 or 1.53.⁷⁹ These two concepts—the treatment of the debt and equity portions of the carrying charge calculation—are relevant only to the portion of the expense that was financed by such debt and equity. In the example above, \$65 was not funded by ADIT. If \$35 of the \$65 were funded by equity, it would be appropriate to “gross up” the interest on the \$35 equity infusion. The interest on the remaining \$30 would be tax deductible; thus, there is no need to “gross up” that portion to ensure that AEP-Ohio recovers its expenses.

The Commission incorrectly asserts that the PIRR Order is lawful because R.C. 4928.144 “makes no mention of an adjustment to account for tax effects.” The phase-in, however, must be just and reasonable and promote state policy. R.C. 4928.02, provides policy guidelines for implementation of R.C. 4928. Of note, the Commission must ensure that customers receive “reasonably priced retail electric service.” R.C. 4928.02(A). Allowing AEP-Ohio to accrue carrying charges on overstated balances fails to ensure that customers receive reasonably priced electricity and causes an unjust and unreasonable result.

Moreover, the PIRR Order’s failure to require an ADIT adjustment prior to calculating carrying charges violates Supreme Court of Ohio and Commission precedent: tax benefits available to the utility must be recognized in customer rates; otherwise, the utility will be overcompensated. *Cleveland Electric v. Pub. Util. Comm.*, 12 Ohio St.3d 320, 323 (1984)

⁷⁹ *Id.*

(holding that “the opinion and order is not only supported by the record, but it also remains consistent with the commission’s policy regarding the pass-through of tax benefits to either present or future customers, depending on the circumstances presented.”); *Ohio Bell Tel. v. Pub. Util. Comm.*, 68 Ohio St.2d 193, 194 (1981); *Cincinnati Gas and Electric v. Pub. Util. Comm.*, 173 Ohio St. 473, 473-476 (1962); *see also Cincinnati v. Pub. Util. Comm.*, 161 Ohio St. 395, 405-06 (1954). Indeed, within one week after issuing the PIRR Order in this proceeding, the Commission determined that the tax benefit of ADIT must be reflected in rates, stating:

We agree with Staff and Kroger that the DIR mechanism be revised to account for ADIT. The Commission finds that it is not appropriate to establish the DIR rate mechanism in a manner which provides the Company with the benefit of ratepayer supplied funds. Any benefit resulting from ADIT should be reflected in the DIR revenue requirement. Therefore, the Commission directs AEP-Ohio to adjust its DIR to reflect the ADIT offset.⁸⁰

By failing to adjust the deferral balance for ADIT when determining carrying charges, the PIRR Order violates over sixty years of legal precedent, and no reasonable justification for deviating from precedent exists.

Finally, the phase-in authorized by the Commission fails to comply with GAAP in violation of the requirements of R.C. 4928.144. In the Fifth Entry on Rehearing, the Commission stated, IEU-Ohio has not explained how the phase-in fails or the regulatory assets fail to comply with GAAP.⁸¹ The Commission further stated that “the question of whether ADIT should be reflected in the calculation of carrying charges to be included in the PIRR is a matter separate and apart from how AEP-Ohio maintains its books pursuant to GAAP.” *Id.*

⁸⁰ *ESP II*, Opinion and Order at 47 (Aug. 8, 2012) (IEU-Ohio Appx. at 132).

⁸¹ *PIRR Case*, Entry on Rehearing at 8 (AEP Appx. at 43).

As IEU-Ohio explained to the Commission in the proceeding below, AEP-Ohio records regulatory assets (deferred expenses) and regulatory liabilities (future revenue reductions or refunds) to reflect the economic effects of regulation by matching expenses with their recovery through regulated revenues and income with its passage to customers through the reduction of regulated revenues.⁸² This treatment is required under GAAP, specifically under Financial Accounting Standards Board (“FASB”) Accounting Standards Codification ASC 980 (former FASB 71). The regulatory asset is capitalized on the asset side of the balance sheet, just like electric plant investment in traditional ratemaking. GAAP follows Accounting Standard Codification (“ASC”) Sections 980-340-25, 980-740-25, and 740-10-25 with respect to regulatory assets and deferred income taxes. GAAP requires AEP-Ohio to account for any tax benefits. By authorizing AEP-Ohio to accrue carrying charges on the regulatory asset without reducing the deferred balance for the ADIT liability, the Commission has violated the underlying spirit and purpose of GAAP’s requirement that tax benefits be accounted for by the utility.

2. The Commission’s Finding and Order is unlawful and unreasonable because the Finding and Order failed to reduce the deferral balance, that customers will pay, to account for the flow-through effects of the remand of the electric security plan.

Embedded in the deferral balance that AEP-Ohio seeks to recover through the PIRR amounts that the Court and Commission have found were not legally authorized. The Commission, however, has refused to reduce the deferral balance. This refusal is unlawful and unreasonable and is currently on appeal in Case No. 2012-017. If the Court reverses the Commission's decision in that appeal, the Court should also ensure that the Commission recognizes the flow-through effects in the PIRR and remand this case to the Commission. In its

⁸² *PIRR Case*, IEU-Ohio Application for Rehearing at 10-12 (IEU-Ohio Appx. at 22-24).

decision issued on April 19, 2011, the Court reversed the Commission's ESP I Opinion and Order. The Court held that the Commission had improperly authorized the POLR charge because "the manifest weight of the evidence contradict[ed] the commission's conclusion that the POLR charge [was] based on cost."⁸³ The Court remanded the issue concerning POLR charges to the Commission. Additionally, the Court held that the Commission had illegally authorized the inclusion of the environmental investments ("Pre-2009 Component") that had not been previously included in rates because the Commission had authorized recovery on the "determination that R.C. 4928.143(B)(2) permit[ted] ESPs to include unlisted items."⁸⁴ This matter was also remanded to the Commission.

In the hearing on remand, IEU-Ohio provided testimony supporting a Commission order addressing the flow-through effects of the Court's remand decision.⁸⁵ IEU-Ohio witness Joseph Bowser testified that the Commission authorized AEP-Ohio to collect a total ESP revenue requirement, but then limited the amount of the total authorized revenue that could be collected during the ESP period ending December 31, 2011.⁸⁶ The residual amount of the total authorized revenue not collected during the ESP period accumulated in the phase-in deferral, which was subject to further review by the Commission and amortization through customer charges imposed after the ESP period. "To the extent the amount of revenue collected by [AEP-Ohio] during the ESP period was based on items that [were] not properly includable in an ESP, the

⁸³ *In re Application of Columbus Southern Power Co.*, 128 Ohio St.3d at 519.

⁸⁴ *Id.* at 520.

⁸⁵ *ESP I*, IEU-Ohio Remand Ex. 3 at 9-11 (IEU-Ohio Appx. at 417-419).

⁸⁶ *Id.* at 10 (IEU-Ohio Appx. at 418).

amount of revenue deferred for future collection has been overstated.”⁸⁷ To address the overstatement of the deferral amounts, Mr. Bowser recommended that the Commission “reduce the total authorized revenue by the amounts not properly collectible as part of an ESP, and subtract the amount actually collected from the adjusted ESP total to determine how much, if any, of the authorized revenue is properly deferred for future collection.”⁸⁸ He testified further that the reduction to the phase-in deferral related to the Pre-2009 Component was \$62.8 million and \$203 million for CSP and OP, respectively, and that the reduction related to the illegal POLR charges was \$235.3 million and \$132.4 million for CSP and OP, respectively.⁸⁹

The Commission rejected the arguments of IEU-Ohio concerning the flow-through effects of the Court’s remand decision on the phase-in deferral balances and other matters.⁹⁰ In refusing to reduce the phase-in deferral balances, the Commission determined that the flow-through recommendations of IEU-Ohio “would be tantamount to unlawful retroactive ratemaking.”⁹¹ The Commission continued, “[w]e cannot order a prospective adjustment to account for past rates that have already been collected from customers and subsequently found to be unjustified.”⁹² After the Commission denied IEU-Ohio’s Application for Rehearing, IEU-

⁸⁷ *Id.*

⁸⁸ *Id.* At the time this matter was heard by the Commission, OP had a substantial outstanding deferral balance resulting from the bill limits the Commission ordered, but CSP did not. *Id.* at 15 (IEU-Ohio Appx. at 423). CSP, however, had other substantial deferral balances in the form of regulatory assets that could have been reduced because of the flow-through effects of the Court’s decision. *Id.*

⁸⁹ *Id.* at 10-11 & 14 (IEU-Ohio Appx. at 418-419, 422).

⁹⁰ *ESP I*, Order on Remand at 34-36 (IEU-Ohio Appx. at 399-401).

⁹¹ *Id.* at 35-36 (IEU-Ohio Appx. at 400-401).

⁹² *Id.* at 36 (IEU-Ohio Appx. at 401).

Ohio filed the appeal that is currently pending in Case No. 2012-0187 on the Commission's refusal to address the flow-through effects of the Court's remand of the ESP I Order and its authorization of continued collection of the Pre-2009 Component.

The crux of IEU-Ohio's Appeal in Case 2012-0187 is that retroactive ratemaking does not bar IEU-Ohio's recommended reduction to the deferred amounts. In *ESP I*, AEP-Ohio's estimate of the phase-in deferred amounts eligible for future collection was a residual calculation. It was the difference between the revenue collected during the ESP period subject to the bill increase limitations and the revenue increases that would have otherwise occurred without such limitations. The difference, AEP-Ohio's estimate of the phase-in deferred amounts was significantly excessive because embedded in the math that produced AEP-Ohio's estimate was an allowance for revenues which cannot be lawfully recognized for purposes of establishing rates and charges. In other words, the principal and interest effects of the illegally authorized charges were embedded in the phase-in deferral because the phase-in deferral dollar amount was accumulated, for accounting purposes, on the assumption that total revenue authorized by the Commission (to be collected during the ESP period and after) included the illegally authorized charges. But for the illegally authorized charges, the phase-in deferral balance subject to future collection would have been substantially less. Consequently, retroactive ratemaking is not a bar to reducing the deferral balance for the unlawfully authorized POLR and environmental investment charges.

Therefore, IEU-Ohio requests that if the Court grants IEU-Ohio's Appeal in Case 2012-0187, the Court must remand this case to the Commission to reduce the deferred amounts to account for the flow-through effects of the remand of AEP-Ohio's ESP.

V. CONCLUSION

In 2009, the Commission invoked R.C. 4928.144 and authorized AEP-Ohio to defer collection of a portion of the increase the Commission authorized in ESP I Order. The ESP I Order did not authorize carrying charge terms to apply to the deferred amounts during the Recovery Period. Because AEP-Ohio's appeal is premised on the fact that the ESP I Order established carrying charge terms for the Recovery Period mechanism, AEP-Ohio's appeal must be denied. Moreover, the Commission's determination that AEP-Ohio must accrue carrying charges at a long-term debt rate is supported by circumstances that existed at the time the Commission issued the PIRR Order.

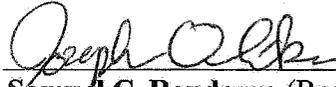
Although the Commission properly directed AEP-Ohio to accrue carrying charges at a debt rate during the Recovery Period, the Commission failed to direct AEP-Ohio to make an ADIT adjustment to the deferral balance upon which carrying charges accrue. Thus, in violation of regulatory practices and principles, precedent, and GAAP, the Commission authorized AEP-Ohio to earn interest on money that AEP-Ohio did not have to borrow from creditors or shareholders. As a result, customers will be overcharged for an interest expense that AEP-Ohio will not actually incur.

Finally, the Commission failed to account for the flow-through effects of the remand in the *ESP I* case. Should the Court grant IEU-Ohio's appeal in Case 2012-0187, the Court must reverse and remand this case to account for the flow-through effects of the remand of AEP-Ohio's ESP.

Therefore, IEU-Ohio respectfully requests that the Court deny AEP-Ohio's appeal and grant IEU-Ohio's cross-appeal. The Court should reverse and remand this case with the instruction that the Commission direct AEP-Ohio to accrue carrying charges on deferred

balances adjusted for ADIT and to account for the flow-through effects of the remand of AEP-Ohio's first ESP.

Respectfully submitted



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CERTIFICATE OF SERVICE

I hereby certify that a copy of this *Second Merit Brief of Appellee/Cross-Appellant Industrial Energy Users-Ohio* was sent by ordinary United States mail, postage prepaid, or hand-delivered to all parties to the proceeding before the Public Utilities Commission of Ohio, listed below, and pursuant to Section 4903.13 of the Ohio Revised Code on April 22, 2013.



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