

IN THE SUPREME COURT OF OHIO

Industrial Energy Users-Ohio, Inc.,	:	
	:	CASE NO. 2013-0228
Appellant,	:	
	:	On Appeal from the Public Utilities
v.	:	Commission of Ohio, Case No. 10-2929-
	:	EL-UNC, <i>In the Matter of the</i>
The Public Utilities Commission of Ohio,	:	<i>Commission Review of the Capacity</i>
	:	<i>Charges of Ohio Power Company and</i>
Appellee.	:	<i>Columbus Southern Power Company.</i>

MERIT BRIEF OF APPELLANT FIRSTENERGY SOLUTIONS CORP.

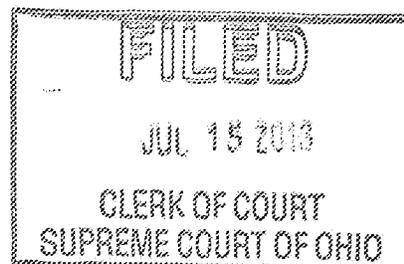
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I. INTRODUCTION

This case involves determining the legally correct price for “capacity.” “‘Capacity’ is not electricity itself but the ability to produce it when necessary.” *Conn. Dep’t of Pub. Util. Control v. FERC*, 569 F.3d 477, 479 (D.C. Cir. 2009). In simple terms, if sufficient capacity resources (such as generating units or demand resources) are available during each hour of every day in order to satisfy aggregate customer demand for electricity – the customer “load,” then service is reliable. Capacity is one of the services that a generator can sell, along with “energy” (or the electricity) that a generation unit produces. A generator can thus receive revenue for the capacity and energy that it can make available and sell.

The Public Utilities Commission of Ohio (“PUCO”) acted contrary to both federal and state law when it relied upon outdated state ratemaking principles to fix a rate for the commitment of capacity by Ohio Power Company (“AEP Ohio”) to load of shopping customers. This rate bestows an anticompetitive above-market subsidy on AEP Ohio’s generating facilities. The Court should reverse the PUCO’s order because it set a rate for AEP Ohio’s capacity committed to shopping load that is entirely disconnected from the reliability principles embodied in controlling federal regulations and ignores Ohio’s rejection of cost-of-service ratemaking for electric generating facilities more than twelve years ago.

Capacity, being a component of regional electric reliability, is under the exclusive jurisdiction of the Federal Energy Regulatory Commission (“FERC”). *Conn. Dep’t of Pub. Util. Control v. FERC*, 569 F.3d 477, 483-85 (D.C. Cir. 2009). FERC, in turn, relies upon entities, known as Regional Transmission Operators (“RTOs”), to develop and administer the appropriate mechanisms to produce workable capacity markets. In Ohio, and for the territory of AEP Ohio, the RTO is PJM Interconnection, LLC (“PJM”).

AEP Ohio's obligation to commit capacity to serve load within PJM is detailed in a FERC tariff – called the Reliability Assurance Agreement (“RAA”). The RAA is an agreement that AEP Ohio and all other generation-owning utilities in the PJM region entered into in 2007. (See Supplement of Appellant FirstEnergy Solutions Corp. (“Supp.”) 143, 147, 168-73.) The RAA requires generation unit owners to provide reliable service to load within the PJM region “in a manner consistent with the development of a robust competitive marketplace.” (Supp. 145.) Under the RAA, capacity prices are largely based on the Reliability Pricing Model (“RPM”). The RPM uses a series of auctions which replicate competitive market behavior. The RPM attempts to set prices based on a subset of costs, called “avoidable” or “to go” costs. Reliability is ensured when entities recover “avoidable” or “to go” costs necessary to continue operating.

The RAA also allows, in limited circumstances, capacity prices to be set based upon a “state compensation mechanism,” i.e., a price established by a state regulatory commission, like the PUCO. In permitting this price-setting authority – as an alternative to the RPM auctions – the RAA nowhere authorizes any state commission to abandon the market principles underlying the RPM and the RAA.

Unfortunately, the capacity rate set in the proceeding below ignores the RAA's twin objectives of achieving reliable service and developing a robust competitive marketplace. The rate set by the PUCO should compensate AEP Ohio for its commitment of capacity “to ensure reliable service to loads in the PJM Region.” (Supp. 158.) In exercising its price-setting authority, however, the PUCO gave no thought to reliability or to competitive markets. Instead, the PUCO used pre-1999 ratemaking principles to ensure that AEP Ohio would recover the full embedded costs of its generating facilities through its capacity rates. A rate based on full embedded costs is utterly antithetical to the RAA and to the development of competitive

markets. Indeed, the PUCO-approved capacity rate for AEP Ohio creates an uneven playing field where AEP Ohio recovers its full embedded costs, while other generation owners in the PJM region are compensated through market-based rates based on avoidable costs (i.e., costs that could be avoided if a generation unit was retired or “mothballed”). Thus, the PUCO erred by granting AEP Ohio an above-market subsidy based on AEP Ohio’s full embedded costs.

In addition to its failings under the RAA, the PUCO’s decision fails no better under Ohio law. As a creation of statute, the PUCO can only act in a manner authorized by Ohio law. *Montgomery County Bd. of Commrs. v. Pub. Util. Comm.*, 28 Ohio St.3d 171, 176, 503 N.E.2d 167 (1986). Thus, whatever the PUCO does on the issue of capacity price, its decision must comply with the RAA and with Ohio law.

Beginning in 2001, Ohio transitioned to a new electric regulatory scheme that substituted market-based rates for traditional cost-of-service ratemaking. This new scheme had two key elements: (1) the development of competitive markets for retail electric generation service; and (2) structural changes to transition electric generating assets from cost-of-service compensation to market-based compensation so as to prevent any unfair competitive advantage. As to the latter, electric utilities had the opportunity during a transition period to recover their embedded generation costs that would not otherwise be recovered in the market through the receipt of “transition revenues.” R.C. §§ 4928.37-.40. Notably, following the end of that transition period, Ohio law mandated that each electric utility “shall be fully on its own in the competitive market.” R.C. § 4928.38.

The PUCO mistakenly determined that AEP Ohio’s commitment of capacity resources to serve shopping load remained subject to traditional ratemaking principles because this commitment under the RAA was not “retail electric generation service.” (Appendix to the Merit Brief of Appellant FirstEnergy Solutions Corp. (“Appx.”) 39 [July 2, 2012 Opinion and Order].)

The flaw in this reasoning is that it ignores Ohio law's elimination of cost-of-service ratemaking for generating assets in favor of fully exposing those assets to competitive markets. Ohio state policy expressly seeks to ensure and promote competitive markets and to preclude a generation-owning electric utility from manipulating its market power or retaining an unfair competitive advantage. R.C. §§ 4928.02, .17. Thus, where the PUCO must set a generation-related rate for an Ohio utility, that rate must reflect market-based prices without any guarantee of full recovery in a utility's embedded costs. The PUCO also must prevent abuse of market power; it may not allow a higher-than-market rate; and it must ensure that a utility receiving such a rate operates on the same playing field as all other market participants. In its decision below, the PUCO authorized AEP Ohio to recover a cost-based rate for capacity that is more than double the applicable market price. In doing so, the PUCO violated Ohio law and policy.

In addition, even assuming that the PUCO's order did not violate federal and Ohio law by approving a full-embedded-cost-based rate,¹ the PUCO's order cannot stand. The PUCO failed to apply the mandatory ratemaking formula required by the Ohio Revised Code to set cost-based utility rates. To be sure, the PUCO has broad authority to institute an investigation of a utility's rates. But once such an investigation leads the PUCO to establish a new cost-based rate, the PUCO must follow the procedures set forth in Chapter 4909. The PUCO did not.

Therefore, for at least three independent reasons, the PUCO's order approving AEP Ohio's recovery of certain capacity charges is unlawful, unreasonable, and should be reversed.

¹ FirstEnergy Solutions Corp. does not address herein the question, raised elsewhere by IEU-Ohio and other appellants, of whether the PUCO has jurisdiction under Ohio law to fix a rate that CRES providers pay to AEP Ohio for AEP Ohio's commitment of capacity to shopping load.

II. STATEMENT OF FACTS

A. Under Federal Policy, Capacity Prices Should Be Market-Based.

1. PJM generation owners make capacity available to provide reliable service to loads within the PJM region either through an auction process or through the Fixed Resource Requirement alternative.

RTOs are responsible for the bulk power systems in the United States. PJM is the RTO that covers Ohio and a wide swath of the eastern United States. (Supp. 8 [FES Ex. 101, Direct Testimony of Robert B. Stoddard (“Stoddard Testimony”)].) Electric generators produce energy that is then transmitted through PJM’s bulk power system. PJM requires that generators transmitting power through PJM’s system also maintain additional capacity that would allow them to produce more energy if needed to ensure that sufficient electric energy is continuously available for customers. (*See id.* at 8-9.) In its role as an RTO, PJM sets the target for the amount of capacity resources that electric generators in its territory must make available to serve customers’ reliability needs. (*Id.* at 8.)

The rules that govern how PJM operates the bulk power system are set forth primarily in the RAA and in Attachment DD of PJM’s Open Access Transmission Tariff. (*Id.* at 8; *see* Supp. 139-173 [FES Ex. 110-A, RAA]; *see also* FES Ex. 110-C, OATT Attachment DD.) Capacity commitments are satisfied through two methods: (1) an auction process called the Reliability Pricing Model (“RPM”) set out in Attachment DD and Schedule 8 of the RAA; or (2) an option called the Fixed Resource Requirement (“FRR”) alternative set out in Schedule 8.1 of the RAA. (Supp. 9-10.) In either case, all entities participating in the PJM market agreed in the RAA to ensure that adequate capacity resources:

will be planned and made available to provide reliable service to loads within the PJM Region, to assist other Parties during Emergencies and to coordinate planning of such resources consistent with the Reliability Principles and Standards. Further, it is the intention and objective of the Parties to implement this

Agreement in a manner consistent with the development of a robust competitive marketplace.

(Supp. 145 (emphasis added).)

2. The RPM process compensates the lowest-cost capacity needed to satisfy PJM load based on generating units' avoidable cost.

The RPM process ensures that sufficient capacity resources are available in a particular June 1 – May 31 “planning year” by establishing capacity prices in: (1) a Base Residual Auction (“BRA”) three years in advance; and (2) additional incremental auctions held each year between the BRA and the start of the applicable planning year. In this way, the least-cost set of capacity resources needed to meet capacity requirements receives the auction clearing price. (Supp. 9-10.)

A critical facet of the RPM is that generators' offers into the auctions are subject to a cap. (Supp. 13-14.) Specifically, generators cannot bid a price higher than their “avoidable cost rate.” (Supp. 14.) Avoidable costs are costs that a generator can avoid by retiring or mothballing the generating facility. These are sometimes referred to as short-term, “to go” costs. (*Id.*) Avoidable costs do not include fixed costs such as depreciation, amortization, taxes, and corporate costs that a generator must bear regardless of whether the business operates or not. (Supp. 14-15.) This broader group of costs are referred to as “embedded costs,” the larger costs associated with the full operation of the business. (*Id.*)

By instituting offer caps based on avoidable costs, capacity pricing in PJM's territory replicates the results that would be expected in a competitive environment. (Supp. 14-15.) In the absence of market power, a generator in a competitive market would be expected to offer capacity at its (lower) short-term, “to go” costs in order to provide the most competitive price. (*See id.*) This is the economically efficient way to price assets for the purpose of ensuring reliability. If a business (a generation supplier) sells a product (capacity) for more than it costs to

make it (the avoidable costs), then it is earning some margin to cover other fixed costs and possibly enough to generate a return on equity. (Supp. 15.) At the same time, the process incentivizes suppliers to reduce their costs and promotes lower prices. On the other hand, if a generation supplier could be guaranteed to sell its product for all of its fixed costs of doing business (embedded costs), it would have no incentive to reduce its costs or to operate efficiently, and there would be no downward pressure on prices. (See Supp. 72 [FES Ex. 102, Direct Testimony of Tony C. Banks (“Banks Testimony”)]; Supp. 111-114 [FES Ex. 103, Direct Testimony of Jonathan A. Lesser (“Lesser Testimony”)].)

The billed RPM price for the 2012/2013 planning year applicable to AEP Ohio’s territory was \$19.89/MW-day. The equivalent RPM price is \$33.87/MW-day for the 2013/2014 planning year and \$153.99/MW-day for the 2014/2015 planning year. (Supp. 115.) The weighted average load price for this three-year period is \$69.22/MW-day. (*Id.*)

3. AEP Ohio unilaterally opted out of the RPM auction process and chose instead to be the sole provider of capacity in its service territory.

AEP Ohio, through its affiliates, advocated at PJM for an alternative to the RPM auction process for certain qualifying entities. (AEP Ohio Ex. 103, Direct Testimony of Dana E. Horton, at p. 5.) Under that option, known as the FRR, an FRR entity must submit a plan to meet the capacity requirements attributable to all of the electric load served through its distribution system – regardless of whether the FRR entity or some other entity supplies the retail generation service for that load. (Supp. 11.)

AEP Ohio and its affiliates elected to become FRR entities as of 2007. (Hearing Transcript (“Tr.”) Vol. II, pp. 394-97.) The AEP entities have stated that they made the FRR election because they believed the FRR election would be better for them than participating in the RPM auction process (Tr. Vol. II, p. 396); the entities could avoid paying auction rates for

capacity and avoid the risk of units not clearing the auction process. AEP Ohio thus chose to be responsible for supplying sufficient capacity resources for all of its distribution customers. AEP Ohio is subject to that binding election through May 31, 2015. (Supp. 11.) As a result of AEP Ohio's FRR election, all Competitive Retail Electric Service ("CRES") providers² that serve customers in AEP Ohio's service territory must pay AEP Ohio for capacity resources allocable to the load of CRES providers' customers until May 31, 2015. (Supp. 11-12.)

4. After consistently charging the RPM market-based price, AEP Ohio sought to charge a price multiple times higher than the market price for capacity.

PJM's RAA establishes specific parameters for the price that an FRR entity can charge to CRES providers for capacity. Schedule 8.1, Section D.8 of the RAA provides:

In a state regulatory jurisdiction that has implemented retail choice, the FRR Entity must include in its FRR Capacity Plan all load, including expected load growth, in the FRR Service Area, notwithstanding the loss of any such load to or among alternative retail LSEs. In the case of load reflected in the FRR Capacity Plan that switches to an alternative retail LSE, where the state regulatory jurisdiction requires switching customers or the LSE to compensate the FRR Entity for its FRR capacity obligations, such state compensation mechanism will prevail. In the absence of a state compensation mechanism, the applicable alternative retail

² A CRES provider is a provider of competitive retail electric service. *Ohio Consumers' Counsel v. Pub. Util. Comm.*, 110 Ohio St.3d 394, 2006-Ohio-4706, 853 N.E.2d 1153, ¶ 4. Retail electric service is defined as:

[A]ny service involved in supplying or arranging for the supply of electricity to ultimate customers in this state, from the point of generation to the point of consumption. For purposes of this chapter, retail electric service includes one or more 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).

LSE shall compensate the FRR Entity at [rest-of-pool or “RTO” clearing prices], provided that the FRR Entity may, at any time, make a filing with FERC under Sections 205 of the Federal Power Act proposing to change the basis for compensation to a method based on the FRR Entity’s costs or such other basis shown to be just and reasonable.

(Supp. 163.) Thus, the RAA establishes a sequence to determine the capacity rate that the FRR entity may charge a CRES provider – called an “alternative retail LSE” in the RAA. If a “state compensation mechanism” exists, it takes precedence. (Supp. 13 [Stoddard Testimony].) The state compensation mechanism applies when load switches to “an alternative retail LSE,” i.e., when customers are switching to CRES providers in a competitive market. If no state compensation mechanism exists, the capacity rate is set at the RPM clearing price. (*Id.*) An FRR entity’s option to file a complaint at FERC to seek cost-based recovery is only available when there is no state compensation mechanism in place. *See American Electric Power Serv. Corp.*, 134 FERC ¶ 61,039, 2011 WL 182468 (2011).

Under this framework, and from 2007 (when AEP Ohio first made its FRR election) through 2010, AEP Ohio charged CRES providers the RPM market-based prices for capacity for their shopping customers. (AEP Ohio Ex. 101, Direct Testimony of Richard E. Munczinski, at pp. 5-6.) Then, on November 24, 2010, AEP Ohio filed an application with the FERC to change the basis by which it was compensated for capacity provided for shopping customers. AEP Ohio requested FERC approval to charge CRES providers a combined rate of \$388/MW-day for capacity. *See American Electric Power Serv. Corp.*, 134 FERC ¶ 61,039, 2011 WL 182468 (2011). In the proceeding here, one AEP Ohio witness testified that AEP Ohio considered its proposed “cost-based” capacity charge to be an “exit fee” on Ohio customers: “In my mind that was the charge that we were going to make to the outside providers for customers exiting our regulated environment.” (Tr. Vol. II, pp. 408-410.) AEP Ohio’s proposed “cost-based” capacity

charge would represent an increase of 166% over the billed RPM market-based price for the 2011/2012 delivery year and of 460% over the average billed RPM market-price for June 1, 2012 through May 31, 2015. (Supp. 115.) AEP Ohio did not notify CRES providers ahead of time that it intended to seek this dramatically higher rate. (Tr. Vol. II, pp. 233-36, 405-08.) As a result, CRES providers did not have the option to opt out of AEP Ohio's FRR plan, which would have been the only avenue CRES providers could have taken to avoid AEP Ohio's proposed increased price.³ (Tr. Vol. II, pp. 233-36, 405-08; Supp. 102.)

In response to AEP Ohio's application with the FERC, the PUCO instituted the underlying proceeding, Case No. 10-2929-EL-UNC, on December 8, 2010, and re-affirmed RPM pricing as Ohio's interim state compensation mechanism for capacity. (Appx. 6-7 [Dec. 8, 2010 Entry].) AEP Ohio was required to continue charging RPM prices for capacity until the PUCO adopted, on December 14, 2011, a two-tiered capacity pricing structure in connection with a stipulation covering AEP Ohio's proposed electric security plan ("ESP"). *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 ("AEP ESP I")*, Case Nos. 11-346-EL-SSO et al., 2011 WL 6543006, at *39-43 (Opinion & Order Dec. 14, 2011). The PUCO later reversed its decision on AEP Ohio's ESP Stipulation and a new hearing process was instituted to consider AEP Ohio's proposed \$355/MW-day capacity price for capacity allocated to shopping customers. *AEP ESP II*, 2012 WL 666167, ¶¶ 20-21 (Entry on Rehearing Feb. 23, 2012). The PUCO also authorized a

³ Prior to the beginning of the AEP Ohio FRR plan, a CRES provider could opt out and file its own plan to secure capacity for the load to be served by that entity. (Supp. 44-46.) That plan would also be an FRR plan and the CRES provider would become an FRR entity. (*Id.*)

modified two-tiered pricing structure for capacity pending its decision after the hearing process. (Appx. 24-25 [Mar. 7, 2012 Entry].)

B. Under Ohio Law, Generation-Related Charges Should Be Market-Based.

1. Ohio created competitive markets for retail electric generation service by unbundling electric services and transitioning electric generating assets away from cost-of-service compensation.

Electric service traditionally was provided to Ohioans through vertically integrated utilities. These utilities generated electric energy at their own generating facilities and then transmitted and distributed the energy to customers located in their certified territories. *See Migden-Ostrander v. Pub. Util. Comm.*, 102 Ohio St.3d 451, 2004-Ohio-3924, 812 N.E.2d 955, ¶¶ 3–5. The vertically integrated utilities recovered the costs associated with the production of the energy and the distribution to customers during a test period, plus a reasonable return on their investment, through bundled rates approved by the PUCO. *See id.* at ¶ 3; *Cincinnati Gas & Elec. Co. v. Pub. Util. Comm.*, 86 Ohio St.3d 53, 53, 711 N.E.2d 670 (1999); R.C. § 4909.15. As this Court noted in 1983, Ohio’s rate-making law balanced investor and consumer interests by assuring investors “a fair and reasonable return on property that is deemed used and useful, R.C. § 4909.15(A)(2), plus the return of costs incurred in rendering the public service, R.C. § 4909.15(A)(4), while consumers may not be charged ‘for utility investments and expenditures that are neither included in the rate base nor properly categorized as costs.’” *Dayton Power & Light Co. v. Pub. Util. Comm.*, 4 Ohio St.3d 91, 103, 447 N.E.2d 733 (1983). However, in 1999, the Ohio General Assembly passed Am. Sub. S.B. 3 (“S.B. 3”) and instituted a new framework for retail electric service.

2. S.B. 3 authorizes retail electric generation service and promotes retail choice through competitive markets.

S.B. 3 “unbundled” electric service into three parts, each of which would be separately priced: the electricity itself (“generation”), the transmission of that electricity across high-voltage power lines (“transmission”), and the distribution of that electricity through local power lines to consumers’ homes and places of business (“distribution”). See *Migden-Ostrander v. Pub. Util. Comm.*, 102 Ohio St.3d 451, 2004-Ohio-3924, 812 N.E.2d 955, ¶¶ 3-4. S.B. 3 provided that, effective January 1, 2001, retail electric generation service was a competitive service. R.C. §§ 4928.01(A)(28), .03. Rather than being required to purchase energy from the local utility, customers were free to shop for generation service from CRES providers:

Beginning on the starting date of competitive retail electric service, retail electric generation, aggregation, power marketing, and power brokerage services supplied to consumers within the certified territory of an electric utility are competitive retail electric services that the consumers may obtain subject to this chapter from any supplier or suppliers.

R.C. § 4928.03. Further, the marketing and sale of electricity to retail consumers would no longer be subject to supervision and regulation by the PUCO except for certain provisions related to service reliability and public safety. R.C. § 4928.05.

The General Assembly established a number of explicit state policies aimed at promoting the competitive market and directed the PUCO to effectuate these policies. R.C. § 4928.06(A) (“Beginning on the starting date of competitive retail electric service, the public utilities commission shall ensure that the policy specified in section 4928.02 of the Revised Code is effectuated.”). For example, it is state policy to:

Ensure the availability of unbundled and comparable retail electric service that provides consumers with the supplier, price, terms, conditions, and quality options they elect to meet their respective needs;

Ensure diversity of electricity supplies and suppliers, by giving consumers effective choices over the selection of those supplies and suppliers and by encouraging the development of distributed and small generation facilities; . . .

Ensure effective competition in the provision of retail electric service by avoiding anticompetitive subsidies flowing from a noncompetitive retail electric service to a competitive retail electric service or to a product or service other than retail electric service, and vice versa, including by prohibiting the recovery of any generation-related costs through distribution or transmission rates; . . . [and]

Ensure retail electric service consumers protection against unreasonable sales practices, market deficiencies, and market power

R.C. § 4928.02(B), (C), (H) and (I). The General Assembly also charged the PUCO to “exercise [its] authority, to resolve abuses of market power by any electric utility that interfere with effective competition in the provision of retail electric service.” R.C. § 4928.06(E)(1).

3. S.B. 3 restructured the electric utility industry.

In order to create properly functioning competitive markets for generation service with all suppliers operating on a level playing field, S.B. 3 also sought to restructure the electric utility industry. *See, e.g., Ohio Consumers’ Counsel v. Pub. Util. Comm.*, 109 Ohio St.3d 328, 2006-Ohio-2110, 847 N.E.2d 1184, ¶ 2. S.B. 3 mandated that utilities separate their generation and distribution operations:

[B]eginning on the starting date of competitive retail electric service, no electric utility shall engage in this state, either directly or through an affiliate, in the businesses of supplying a noncompetitive retail electric service and supplying a competitive retail electric service, . . . unless the utility implements and operates under a corporate separation plan that is approved by the public utilities commission under this section, is consistent with the policy specified in section 4928.02 of the Revised Code, and achieves all of the following:

(1) The plan provides, at minimum, for the provision of the competitive retail electric service or the nonelectric product or

service through a fully separated affiliate of the utility, and the plan includes separate accounting requirements, the code of conduct as ordered by the commission . . . and such other measures as are necessary to effectuate the policy specified in section 4928.02 of the Revised Code.

R.C. § 4928.17(A) (emphasis added). Thus, as of January 1, 2001, no electric utility was authorized to provide both generation and distribution service to customers, except through a “fully separated affiliate” operating pursuant to a PUCO-approved corporate separation plan. R.C. §§ 4928.02(A)(28), .17(A)(1).⁴ Each corporate separation plan had to satisfy “the public interest in preventing unfair competitive advantage and preventing the abuse of market power” while ensuring “that the utility will not extend any undue preference or advantage to any affiliate, division, or part of its own business engaged in the business of supplying the competitive retail electric service.” R.C. § 4928.17(A)(2)-(3). Thus, generating assets formerly owned by a vertically-integrated utility were to be moved into a separate affiliate (or divested completely) and the remaining “electric distribution utility” was prohibited from seeking a competitive advantage or extending an undue preference to its generation affiliate. The General Assembly did authorize the PUCO to grant a utility a waiver from the requirement for full corporate separation upon “good cause shown” if the utility maintained “functional” separation, but only for an “interim period.” R.C. § 4928.17(C).

The restructuring of Ohio’s electric utility industry to move electric generating facilities from cost-of-service regulation to market-based compensation raised concerns that utility assets would be confiscated and, as a result, the General Assembly established a process under which electric utilities could accelerate recovery of certain costs that otherwise would be “stranded”

⁴ Utilities also were required to transfer control of their transmission assets to a regional transmission organization. R.C. § 4928.12.

(i.e., not recoverable) in competitive markets. *See* R.C. §§ 4928.37-.40. These defined costs could be recovered over a “market development period” established for each utility. *See* R.C. §§ 4928.31, .40. However, in no case could such “transition costs” be recovered after December 31, 2010. R.C. § 4928.40. Thereafter, S.B. 3 prohibited the PUCO from authorizing “the receipt of transition revenues or any equivalent revenues by an electric utility except as expressly authorized.” R.C. § 4928.38. At the end of the transition period, “the utility shall be fully on its own in the competitive market.” *Id.* “In short, each service component was required to stand on its own.” *Migden-Ostrander*, 102 Ohio St.3d 451, 2004-Ohio-3924, 812 N.E.2d 955, ¶ 4.

4. AEP Ohio transitioned its generating assets to market as mandated by S.B. 3, but has yet to complete corporate separation.

In 1999, AEP Ohio submitted a plan to unbundle its retail services, separate its generation and distribution assets, and recover its stranded costs. In the transition plan, AEP Ohio estimated stranded costs of between \$894 million and \$953 million. (Supp. 117.) AEP Ohio and other interested parties eventually submitted a stipulation, which was approved by the PUCO with modifications. *In the Matter of the Application of Columbus Southern Power Company for approval of an Electric Transition Plan and Application for Receipt of Transition Revenues*, PUCO Case Nos. 99-1729-EL-ETP and 99-1730-EL-ETP, 2000 WL 1873290, Opinion and Order at *4-7, 42-43 (Sept. 28, 2000) (“ETP Order”). Among other things, AEP Ohio agreed, and the PUCO ordered, that AEP Ohio would not impose lost revenue charges or “generation transition charges” on any shopping customer to recover its stranded costs. *Id.* at *13; Supp. 176 (FES Ex. 106, ETP Stipulation). An AEP Ohio witness explained at the time that AEP Ohio was waiving any right it had to recover the difference between the embedded cost of its generating assets and the market rate for generation:

The purpose, as I understand it, of the generation transition charge was to collect above market generation costs. The typical

stranded costs. This gets a little complicated because in our filing, even though we had shown that we had stranded costs on a typical 20-year revenue present-value calculation, we were seeking the lost revenue charge, which is more tied to that FERC formula that says if you are a customer that leaves the utility, you pay me the difference between the market rate and what your embedded generation rate is.

So as part of the stipulation, let's go to the stipulation first, Section IV, what we agreed to is not to seek or to drop our seeking of the lost revenue charge.

(Supp. 209 [FES Ex. 107, ETP Hearing Transcript]; *see also* Supp. 215-16.) AEP Ohio was authorized to recover approximately \$616 million in regulatory transition costs ("RTC") over a 7-8 year window. ETP Order at *15, 43; *see* R.C. § 4928.39 (requiring PUCO to identify portion of transition costs that are regulatory assets). AEP Ohio agreed that the RTC revenues, along with its frozen generation rates, would provide it with sufficient revenues to recover all regulatory assets. *See id.* at *6. AEP Ohio's transition period for recovery of any and all of its regulatory transition costs ended on December 31, 2008. (Supp. 177, 193-94 [FES Ex. 106, ETP Stipulation].) Accordingly, as of December 31, 2008 – over four years ago – AEP Ohio's generating assets were fully on their own in the competitive market. R.C. § 4928.38.

However, AEP Ohio's generating assets have remained, and will remain until January 1, 2014, under the ownership and control of AEP Ohio instead of a separate affiliate. AEP Ohio agreed to complete corporate separation over ten years ago as part of its ETP proceeding, but the PUCO later consented to "functional" separation of AEP Ohio's generation operations on an interim basis. *See* ETP Order at *14; *see In the Matter of the Application of Ohio Power Company for Approval of an Amendment to its Corporate Separation Plan*, Case No. 12-1126-EL-UNC, 2012 WL 5246651, Finding and Order at ¶ 11(a) (Oct. 17, 2012). Thus, AEP Ohio continues to own numerous electric generating facilities in Ohio and to directly provide retail electric generation service to its customers despite the statutory requirement that electric utilities,

as of January 1, 2001, not provide such service. R.C. § 4928.17(A). As a result, AEP Ohio continues to have a business interest in promoting its own generation service.

Not surprisingly, AEP Ohio's continued control of generation assets has resulted in its management seeking to prevent customers from shopping for generation service, and AEP Ohio's switching rate, through December 31, 2011, was by far the lowest in the state. (Supp. 78-80.) AEP Ohio even boasted in 2011 that its proposed cost-based capacity charge to CRES providers would significantly constrain shopping to only those customers that could access market pricing for capacity. (Supp. 80.)

5. Competition benefits customers and Ohio's economy.

Since the passage of S.B. 3, Ohio's competitive markets for electric generation service have developed significantly. FirstEnergy Solutions Corp. ("FES") is an active participant in the retail and wholesale energy markets in Ohio and serves customers in all utility service territories. (Supp. 70 (Banks Testimony).) Over 1.7 million Ohio customers are taking the opportunity to shop for retail electric generation service. (Supp. 72.) And customers are now experiencing many of the benefits that competition brings and that were sought by the General Assembly in enacting S.B. 3.

Competition is the best way to promote lower generation prices for customers, to promote greater productivity and efficiencies from the numerous existing generating plants, to reduce the risk imposed on customers, and to provide the appropriate market signals regarding the need for new generation. . . .

A competitive market encourages electric suppliers to reduce their costs in order to earn the ability to serve more customers. These cost reductions may come from reduced supplier profits or increased operating efficiencies. The cost reductions are then reflected in lower prices that are enjoyed by all customers.

(Supp. 72-73).

The testimony in this proceeding illustrated the benefits of competition that have been enjoyed by Ohio customers to date. A coalition of school entities explained that it “decided to join forces and work to cooperatively reduce” its members’ electricity costs, eventually negotiating with various suppliers. (Tr. Vol. IX, p. 1759.) As a result, the participants in the Power4Schools program have saved an estimated \$20 million on their electricity costs. (*Id.*) The Lima Refining Company testified that to mitigate its significant costs for electricity, Lima Refining “shopped the generation portion of our electric bills in recent years to take advantage of the attractive market rates in order to continue to be competitive in our market sector.” (Ohio Manufacturers’ Association (“OMA”) Ex. 103-A, p. 3.) Other manufacturing customers testified similarly. (*See* OMA Ex. 104-A, p. 3; OMA Ex. 102-A, p. 3; OMA Ex. 101-A, p. 3.) FES conservatively estimated that in the FirstEnergy Ohio utilities’ service territory alone, shopping customers have saved over \$100 million each year. (Supp. 73.) But, unfortunately, the competitive market has not developed equally in all parts of the state. (Supp. 78-79.)

C. The PUCO Fixed A Rate For AEP Ohio’s FRR Capacity Obligation of \$188.88/MW-Day, More Than Double The Market Price.

In Case No. 10-2929-EL-UNC, after weeks of hearings and significant intervenor participation, the PUCO established a state compensation mechanism based on AEP Ohio’s purported full embedded costs in its July 2, 2012 Opinion and Order (“Order”). (Appx. 27-65.) AEP Ohio will be allowed to recover \$188.88/MW-day for its capacity. (Appx. 48.) More specifically, the state compensation mechanism encompasses two charges: (1) a charge to CRES providers equal to the applicable RPM price for capacity; and (2) a deferral of “incurred capacity costs not recovered from CRES billings . . . to the extent that the total incurred capacity costs do

not exceed” \$188.88/MW/day⁵ – i.e., the difference between the RPM prices and \$188.88/MW-day. (Appx. 49, 59.) This deferred difference between the RPM prices and \$188.88/MW-day is to be recovered from all customers through a rider established in AEP Ohio’s ESP II proceeding. (Appx. 49.) The PUCO’s Order would allow AEP Ohio to recover more than double the market-based price that all other PJM generators receive for their capacity. (See Supp. 27.) While the PUCO authorized AEP Ohio to recover the equivalent of \$188.88/MW-day, all other generators will recover the equivalent of \$69.22/MW-day between June 1, 2012 and May 31, 2015. (Supp. 115.)

III. ARGUMENT

A. **Proposition of Law No. 1: The PUCO may not establish a rate for an FRR entity’s capacity obligation by reference to full embedded costs because such a rate conflicts with applicable FERC tariffs.**

The PUCO erred in establishing a cost-based state compensation mechanism based on AEP Ohio’s purported full embedded costs. (See Appx. 48, 59-61 [July 2, 2012 Order].) Because a state compensation mechanism only can be approved in a state with retail choice (which includes Ohio), an FRR entity already receives market-based energy pricing as compensation toward recovering the costs of its generating assets. In addition to this market-based energy revenue, the state compensation mechanism serves the purpose of paying an FRR entity for fulfilling its FRR obligation of committing capacity resources to ensure reliable service to shopping load. (See Supp. 158, 163 [RAA].) As described in the RAA, the payment for fulfilling this FRR capacity obligation should be set at the level that ensures adequate capacity resources are available to provide reliable service. (See Supp. 145 (“This Agreement is intended

⁵ The PUCO’s \$188.88/MW-day price represents a modification of Staff’s calculation, which, in turn, is based on AEP Ohio’s purported embedded cost calculation. (See Appx. 59-61.)

to ensure that adequate Capacity Resources . . . will be planned and made available to provide reliable service to loads within the PJM Region”).)

In developing the state compensation mechanism, the PUCO relied upon a cost-of-service formula that calculates a rate by reference to the full embedded costs of AEP Ohio’s generating assets. But this traditional approach has nothing to do with ensuring that adequate capacity resources are available to provide reliable service for shopping load under Schedule 8.1, Section D.8 of the RAA. Because AEP Ohio’s capacity resources are existing generating facilities, the rate should be set at the minimum level necessary to keep these facilities operating⁶ – which is determined by the facilities’ avoidable costs. Because the RAA does not contemplate recovery of embedded costs, the PUCO’s Order unlawfully conflicts with the RAA by basing AEP Ohio’s cost-based recovery on its full embedded costs.

Schedule 8.1, Section D.8 of the RAA provides that, in a state with retail choice, if a state regulatory jurisdiction requires shopping customers or CRES providers to compensate an FRR entity for its FRR capacity obligations, “such state compensation mechanism will prevail.” (Supp. 163 [RAA]; Supp. 12-14 [Stoddard Testimony].) Under the RAA, capacity is a regulatory construct in which PJM sets the level of demand that all FRR entities and RPM auction participants must satisfy to secure reliability for the PJM system. (Supp. 125-126 [Tr. Vol. VIII].) The “FRR capacity obligation” is defined in the RAA as the means by which an FRR entity may “satisfy its obligation hereunder to commit Unforced Capacity to ensure reliable service to loads in the PJM Region.” (Supp. 158; *see* Supp. 151.) Under the RAA, PJM determines the Forecast Pool Requirement for each planning year for all parties, including FRR

⁶ This proposition sets to one side whether AEP Ohio could prudently satisfy its FRR capacity obligation with market purchases at a lower cost.

entities, “to ensure a sufficient amount of capacity to meet the forecast load plus [adequate] reserves” (Supp. 148, 155-156.) The purpose of the Forecast Pool Requirement is “to establish the level of Capacity Resources that will provide an acceptable level of reliability consistent with the Reliability Principles and Standards.”⁷ (Supp. 155.) Because AEP Ohio is an FRR entity, its FRR capacity obligation is its share of the Forecast Pool Requirement as determined by PJM. (Supp. 161.) To satisfy this obligation, AEP Ohio may use megawatts of net capacity from any existing or planned generating facilities accredited to the PJM region, regardless of whether they are owned by AEP Ohio, and any load reduction capability accredited to the PJM region. (Supp. 144, 152.) Under Schedule 8.1, Section D.8 of the RAA, the state compensation mechanism compensates AEP Ohio for committing these capacity resources to shopping load in its service territory.

Robert Stoddard, one of the drafters of the RAA, testified that a generation owner will keep a facility operating, and thus contribute to the capacity resources need for reliable service, as long as it covers its “to go” costs – i.e., the costs that could be avoided by retiring or “mothballing” an existing unit for a year. (Supp. 4, 14-15.) Mr. Stoddard provided the example of an existing power plant with \$50 million of “to go” costs that could be avoided by closing the plant, and \$40 million of “sunk costs,” such as debt service and property taxes, that would be unaffected by closing the plant. Mr. Stoddard asked whether the plant owner would accept capacity revenues of \$60 million to keep the plant operating or whether this would result in the owner mothballing the plant. (Supp. 15-16.) The embedded costs of the plant in this example

⁷ The “Reliability Principles and Standards” are principles and standards established by the North American Electric Reliability Council to define, among other things, an acceptable probability of loss of load due to inadequate generation or transmission capability. (Supp. 144.5 [RAA].)

are \$90 million, but these costs are irrelevant to the reliability question. Because any amount above \$50 million covers the “to go” costs and contributes margin to cover the sunk costs, any economically rational owner would accept the \$60 million payment instead of shuttering the plant and losing the full \$40 million in sunk costs. (*Id.*) Thus, compensation based on avoidable costs ensures that adequate capacity resources are committed to reliable service, which is why avoidable costs are the basis of the RPM and are the only costs discussed or referred to in the RAA. (Supp. 18; *see* Tr. Vol. II, pp. 386-87.)

Mr. Stoddard summarized why avoidable costs were the appropriate and only costs to consider in pricing capacity:

The appropriate capacity price is the RPM RTO auction price, regardless of whether this is viewed in the long or short run. In the short run, the RPM auction price is the “right price” in terms of economic efficiency. It is the closest approximation to the market value of the reliability value of capacity. We maximize efficiency by pricing or transferring commodities at their market price, so that there is a rational trade-off between the value captured by utilizing a good versus selling it in the market. In the long run, the RPM is designed to provide the appropriate incentives for the entry of new, cost-efficient resources and the exit of inefficient resources over a suitably long investment horizon. . . . Because the RPM RTO auction price is efficient in both the long- and short-term, it follows that setting any other price is less efficient and results in economic distortions.

(Supp. 23.)

Mr. Stoddard further explained that the purpose and context of the FRR option in the RAA is inconsistent with a capacity price based on embedded costs:

[M]y view of it as we wrote this [i.e., the RAA], we were talking just about avoidable costs. We were trying to set up a market structure that didn’t turn the FRR into some way that a regular entity could get a really big number, whereas if they were going to be in the RPM, they would do poorly.

What we would have done then is create an exception that swallowed the rule. Everyone that could have taken that option

would have chosen to get some high value. The point of this market is to be comprehensive. The point of the FRR was to allow a very limited carve-out for firms that had regulatory reasons and state reasons to seek a different structure.

(Supp. 131 [Tr. Vol. VIII].) Mr. Stoddard's testimony on these points was un rebutted. Both the RPM auction provisions and the RAA set the value of capacity at the level required to ensure reliability – not to recover full embedded costs. (Supp. 125.) Therefore, if a state compensation mechanism is established in a retail choice state to compensate an FRR entity for committing capacity to ensure reliable service to shopping load, the state compensation mechanism must be based either on market prices or the FRR entity's avoidable costs.

Indeed, in approving the RPM, the FERC concluded that an auction mechanism using avoidable costs instead of full embedded costs would be the least costly approach to customers. According to the FERC, "RPM is based on the premise that competition in properly designed markets will produce just and reasonable prices." *In re PJM Interconnection, LLC*, 121 FERC ¶ 61,173 at ¶ 3 (2007) (quoting *In re PJM Interconnection, LLC*, 119 FERC ¶ 61,318 at ¶ 191). FERC determined that, with RPM, the required reliability can be obtained at a lower overall cost to customers. *Id.* The FERC further explained the benefits of RPM's competitive orientation as compared to a traditional cost-of-service approach as follows:

Such competitive market mechanisms provide important economic advantages to electricity customers in comparison to cost of service regulation. For example, a competitive market with a single, market-clearing price creates incentives for sellers to minimize their costs, because cost-reductions increase a seller's profits. And when many sellers work to minimize their costs, competition among them keeps prices as low as possible. While an efficient seller may, at times, receive revenues that are above its average total costs, the revenues to an inefficient seller may be below its average total costs and it may be driven out of business. This market result benefits customers because over time it results in an industry with more efficient sellers and lower prices.

In re PJM Interconnection, LLC, 121 FERC ¶ 61,173 at ¶ 32 (quoting *In re PJM Interconnection, LLC*, 117 FERC ¶ 61,331 at ¶ 141). The FERC expressly rejected embedded cost recovery as inferior to market-based mechanisms for capacity pricing. *Id.* at ¶¶ 31-32.

Importantly, AEP Ohio and the other LSEs that are signatories to the RAA are contractually bound “to implement [the RAA] in a manner consistent with the development of a robust competitive marketplace” such as now exists in Ohio. (Supp. 145.) Accordingly, any state compensation mechanism must further competitive markets. As Mr. Stoddard explained:

It is understood that any state compensation mechanism should be part of a larger regulatory framework in a state to implement competitive retail access. The state compensation mechanism should, therefore, operate so as not to discriminate against competitive retail suppliers or to discourage competition.

(Supp. 19.)

The PUCO’s state compensation mechanism for AEP Ohio violates both of the prohibitions that Mr. Stoddard noted. First, allowing AEP Ohio to recover its embedded costs for capacity provides AEP Ohio with a price that is above the market price – something that no other generation supplier in Ohio receives. (Supp. 21-22.) Second, the state compensation mechanism makes AEP Ohio potentially more attractive to customers as a supplier of retail generation. (Supp. 20.) Mr. Stoddard explained the discriminatory disadvantage that competitive suppliers would suffer if the state compensation mechanism allowed the recovery of embedded costs:

[F]aced with the choice of paying AEP Ohio a retail rate equal to the sum of the embedded capacity cost rate plus *at-cost* generation, or paying a CRES provider the same AEP Ohio embedded cost rate plus *market* generation, a customer’s preference would be to be a retail customer of AEP Ohio.

(Supp. 20 (emphasis in original).) Thus, the state compensation mechanism adopted by the PUCO makes it more likely that customers will not shop for electric generation service and will

stay with AEP Ohio. The PUCO's state compensation mechanism provides an advantage and a preference to AEP Ohio that is inconsistent with the level playing field required for a competitive market. As a result, the ability of customers to access savings will be constrained as CRES providers are unable to compete head-to-head with AEP Ohio's subsidized generation. (Supp. 73-74 [Banks Testimony].)

Moreover, allowing recovery of embedded costs makes little sense given the terms and overall structure of the RAA. The RAA never uses the term "embedded cost." (Supp. 18-19.) Mr. Stoddard testified that the only cost that should be considered as part of a state compensation mechanism is avoidable cost:

Any other definition of "cost" would provide FRR Entities a (presumably higher) rate that cannot be earned by entities participating in the RPM; consequently, such treatment would encourage some entities to opt out of the RPM auction structure to seek higher capacity rates. But the design intent of RPM was to provide a comprehensive framework for PJM. The FRR Alternative was always viewed as an exception, not the rule, offered for the narrow purpose of helping FRR Entities manage their own portfolios. The FRR Alternative was not intended to create the opportunity for substantial unjust enrichment by opting out of RPM auctions.

(Supp. 30.)

In its Order, however, the PUCO authorized AEP Ohio to collect \$188.88/MW-day for its FRR capacity obligation, based on AEP Ohio's *embedded* costs, although this rate far exceeds both market pricing and AEP Ohio's *avoidable* costs. (See Appx. 59-62.) The PUCO's state compensation mechanism includes costs that are not avoidable costs, e.g., AEP Ohio's prepaid pension assets, severance program costs, and an adjustment to guarantee AEP Ohio a certain return on equity. (*Id.*) As explained by Mr. Stoddard, AEP Ohio's avoidable costs are much lower than \$188.88/MW-day and are, in fact, much lower than current RPM prices. (Supp. 32, 37; *see also* Supp. 115-16.) Had AEP Ohio demonstrated that its avoidable generation costs

justified a rate for its FRR capacity obligation that exceeded market-based rates, the PUCO may have authorized a charge to CRES providers that exceeded those market-based rates. But the unrebutted evidence demonstrated that AEP Ohio's avoidable costs did not justify an above-market rate. Yet the PUCO approved a \$188.88/MW-day charge based on AEP Ohio's full embedded costs that is completely unrelated to ensuring reliability in the PJM region and that fails to promote the development of a robust competitive market – the two important and fundamental goals of PJM's RAA.

Compensation for FRR capacity obligations based on avoidable costs is the only cost-based compensation consistent with the RAA. The PUCO's Order authorizing AEP Ohio to recover an above-market charge for its capacity based on embedded costs is unlawful and unreasonable.

B. Proposition of Law No. 2: The PUCO lacks the authority to approve above-market revenue for an incumbent electric utility's generating assets.

1. Under Ohio law, generation service is competitive and generation assets are not subject to cost-of-service regulation.

The PUCO's Order is contrary to the establishment of competitive retail electric generation service and the restructuring of the electric utilities in Ohio through S.B. 3. The PUCO is a creature of statute and has only that authority granted to it by the General Assembly through Ohio law. *Montgomery County Bd. of Commrs. v. Pub. Util. Comm.*, 28 Ohio St.3d 171, 176, 503 N.E.2d 167 (1986). The PUCO no longer has authority over retail electric generation service. The PUCO justified its Order by considering capacity to be a wholesale service, not a retail one. (Appx. 39.) But this ignores that generation assets in Ohio are to be fully exposed to the competitive market and no longer may be subsidized with above market charges approved by the PUCO.

Since 2001, Ohio law has required that retail electric generation service be a competitive service that consumers may obtain from any supplier. R.C. § 4928.03. The PUCO is charged with carrying out the state's policies to promote and protect the competitive market. R.C. §§ 4928.02, .06(A). The General Assembly's intent to ensure that retail electric generation service in Ohio is competitive, and largely exempt from PUCO regulation, is explicitly set forth across numerous statutes and policies. *See, e.g.,* R.C. § 4928.02 *et seq.*

To be sure, the transition from vertically-integrated utilities (providing a bundled service) to unbundled utilities (with regulated distribution operations and unregulated generation operations) has not been an easy one. To ensure that markets developed as intended, the General Assembly had to restructure the electric industry and separate the non-competitive and competitive operations of incumbent electric utilities to create a level playing field for all suppliers. The state's pro-competition policies could not be achieved if the generating assets of incumbent electric utilities continued to be compensated on a cost-of-service basis. (That would hardly be fair or competitive, given that non-utility generation suppliers could not receive such guaranteed rates.) Thus, during a market development period, those utilities were given the opportunity to receive transition revenues to recover embedded generation costs that would not be recovered in the competitive market. *See* R.C. §§ 4928.37-.40. Once the transition revenues terminated (which occurred for AEP Ohio in 2008), each incumbent electric utility was supposed to "be fully on its own in the competitive market." R.C. § 4928.38. All but two of the generating assets for which AEP Ohio seeks cost-of-service regulatory treatment in this proceeding were legacy generating assets entitled to receive transition revenues that must now, by virtue of R.C. § 4928.38, be fully on their own in the competitive market. (Tr. Vol. II, pp. 254-55; AEP Ohio Ex. 144, Rebuttal Testimony of Eugene T. Meehan, Ex. ETM-3.)

To prevent the incumbent electric utilities from maintaining any unfair competitive advantage or abusing any possible market power, the General Assembly also mandated that the generation operations of each incumbent electric utility be separated into an affiliate, if not divested completely. R.C. §§ 4928.12, .17. In fact, AEP Ohio initially agreed to achieve this structural corporate separation as part of its electric transition plan, but later was granted functional separation on an interim basis. *See* ETP Order at *14; *In the Matter of the Application of Ohio Power Company for Approval of an Amendment to its Corporate Separation Plan*, Case No. 12-1126-EL-UNC, 2012 WL 5246651, Finding and Order at ¶ 11(a). The clear objective of S.B. 3 was to eliminate any incentive of an incumbent electric utility to favor its generating assets in an anti-competitive manner. The General Assembly understood that robust competitive markets could not be established in Ohio if incumbent electric utilities retained the incentive to seek PUCO authorization of above-market subsidies for their legacy generating assets.

Remarkably, AEP Ohio voluntarily elected the FRR status starting in 2007 while it was – and had been for six years – operating within the competitive market. It used its unique position as a utility with a distribution load to secure a monopoly over capacity in its service territory and then seek to recover above-market revenues from its customers associated with that generation-related service. As noted, AEP Ohio’s ability to recover its fully embedded capacity costs puts it at a competitive advantage versus other generation suppliers in Ohio by: (1) allowing AEP Ohio to receive above-market revenues; and (2) allowing AEP Ohio to undercut other generation suppliers to provide generation service to customers. Such conduct exemplifies the abuse of market power that the PUCO is charged to protect against. *See* R.C. § 4928.02(I) (establishing state policy to “[e]nsure retail electric service consumers protection against unreasonable sales practices, market deficiencies, and market power.”); R.C. § 4928.06 (requiring the PUCO to carry out state policy and ensure effective competition). The only way to provide such

protection and promote the competitive market is to maintain the exposure of AEP Ohio's generating assets to competitive markets:

[I]f you have a company, who by virtue of its own decisions determines that it wants to be a monopoly, which AEP through the election of FRR had decided it wants to be a monopoly in its service territory, so that monopoly now has market power over all the customers in its service territory. So I believe that when you have market power, the best indication of the appropriate price that a monopoly that has market power should charge is the market-based price; otherwise, monopolies would be able to charge anything they want AEP is the only company that would be able to get that above-market capacity value in a market that's readily able and willing to offer capacity at RPM prices.

(Supp. 138 [Tr. Vol. VIII, Banks cross-exam].) There is no support in Ohio law for the PUCO's decision to grant AEP Ohio an above-market subsidy of its generating assets.

2. Cost-of-service capacity rates cannot be justified on the ground that capacity is "wholesale."

In its Order, the PUCO attempts to avoid S.B.3's mandates for competitive generation markets by characterizing capacity as a wholesale service, not a retail electric service under Chapter 4928 of the Revised Code. (Appx. 39, 48.) As characterized by the PUCO, because the capacity charge is payment for a wholesale service not subject to Chapter 4928's terms, the PUCO is free to apply traditional cost-of-service rate-making. (Appx. 48.) Yet this is an unreasonably narrow reading of Chapter 4928, which deals with not only the development of a competitive market for retail electric service but also the elimination of cost-of-service regulation for the electric generating assets of incumbent electric utilities. Sections 4928.02, 4928.12, 4928.17 and 4928.37-40 would be rendered mere surplusage under the PUCO's narrow reading. Because the capacity charge approved by the PUCO provides above-market revenues to AEP Ohio's generating assets, it cannot stand.

The PUCO's reliance on Chapters 4905 and 4909 in this proceeding completely eviscerates the purpose and impact of the General Assembly's passage of S.B. 3 and its creation of competitive markets in Ohio. The PUCO should not be permitted to circumvent the specific requirements of Chapter 4928 and look to Chapters 4905 and 4909 for some authority or "obligation" to give AEP Ohio guaranteed, above-market revenue for its generating assets. (*See* Appx. 102 [Oct. 17, 2012 Entry on Rehearing].) Ohio law requires that both generation service and generation assets are to be market-based, and the PUCO cannot ignore its charge under Chapter 4928 by failing to require AEP Ohio to separate its generation service and then relying on a wholesale v. retail distinction. To the extent the PUCO has any authority to set a generation-related rate imposed by a utility, the PUCO must recognize, promote, and ensure that the rate is consistent with the competitive market for generation service in Ohio.

Further, the PUCO overlooks that AEP Ohio's commitment of capacity resources is to its retail load, both shopping and non-shopping. As described in Schedule 8.1 of the RAA, "[t]he Fixed Resource Requirement ("FRR") Alternative provides an alternative means, under the terms and conditions of this Schedule, for an eligible Load-Serving Entity to satisfy its obligation hereunder to commit Unforced Capacity to ensure reliable service to loads in the PJM Region." (Supp. 158.) In a state with retail choice, an FRR entity must include all load in its capacity plan submitted to PJM, including all shopping load. (Supp. 163.) Under Schedule 8.1, Section D.8 of the RAA, a state regulatory jurisdiction may direct either shopping customers or CRES providers to compensate the FRR entity for meeting its FRR capacity obligations to the shopping load. (*Id.*) As such, the FRR capacity obligation is provided to retail load.

While capacity may involve certain wholesale aspects and trigger FERC jurisdiction, capacity is a retail concept in Ohio. R.C. § 4928.01(A)(27) defines "retail electric service" to include "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.” Ohio law makes sparse mention of capacity, but when it does it unites capacity with energy as the retail product sold to retail customers. *See* R.C. § 4928.142(C) (“All costs incurred by the electric distribution utility as a result of or related to the competitive bidding process or to procuring generation service to provide the standard service offer, including the costs of energy and capacity and the costs of all other products and services procured as a result of the competitive bidding process, shall be timely recovered through the standard service offer price”); R.C. § 4928.143(B)(2)(a) (“Automatic recovery of any of the following costs of the electric distribution utility, provided the cost is prudently incurred: . . . the cost of purchased power supplied under the offer, including the cost of energy and capacity”); R.C. § 4928.20(J) (“Such market price shall include, but not be limited to, capacity and energy charges”). Thus, capacity committed to retail load under the RAA is a component of generation service necessary to provide retail electric service to customers “from the point of generation to the point of consumption.” Simply because the PUCO mischaracterizes these transactions does not entitle AEP Ohio to cost-of-service ratemaking for its generating assets committed as capacity resources to ensure reliable service to the shopping load in its service area.

Indeed, the PUCO’s Order treats capacity as a retail charge. The PUCO authorized AEP Ohio to recover the above-market component of the state compensation mechanism through a deferred charge paid directly by retail customers. (*See* Appx. 49-50.) Therefore, whatever the name the PUCO may apply to AEP Ohio’s FRR capacity obligation, the PUCO is treating at least part of the state compensation mechanism as a retail charge.

The PUCO cannot institute an above-market, anti-competitive retail charge and ignore the numerous Ohio laws that require such retail services to be competitive by simply anointing

the service as “wholesale.” Thus, its Order granting AEP Ohio a guaranteed, above-market revenue stream for its generating assets is contrary to Ohio law and unreasonable.

3. The PUCO’s intermingling of AEP Ohio’s regulated and unregulated operations is improper and unlawful.

The PUCO’s reliance on “evidence” of AEP Ohio’s anticipated return on equity over the next few years in justifying the above-market state compensation mechanism illustrates the impropriety of its mixing of AEP Ohio’s regulated and unregulated services. The PUCO relied on AEP Ohio’s estimates of returns on equity for its combined operations – distribution and generation – to support its award of a subsidy to prop up AEP Ohio’s generating assets: “The record . . . reflects that, if RPM-based capacity pricing is adopted, AEP Ohio may earn an unusually low return on equity of 7.6 percent in 2012 and 2.1 percent in 2013” (Appx. 49.) Yet using the earnings of AEP Ohio’s generating assets to present a purportedly dire picture of AEP Ohio as a whole clearly violates the separation mandate of Section 4928.17, Revised Code. Moreover, as discussed above, Ohio law requires that AEP Ohio’s generating assets shall be fully on their own in the competitive market from December 31, 2008 forward. R.C. § 4928.38; Supp. 177, 193-194 [ETP Stipulation]. If AEP Ohio’s ability to provide distribution service was threatened, it could seek to increase its distribution rates pursuant to an application under Section 4909.18, Revised Code. This proceeding was not instituted under that section and, as further discussed below, did not meet the requirements of Chapter 4909. There is no legal basis on which the PUCO, in setting market-based rates for AEP Ohio’s capacity service, can consider the impact on AEP Ohio’s return on equity resulting from generation-related costs. Those costs are required by law to be recovered in the competitive market.

The PUCO's Order, which allows AEP Ohio to recover above-market, cost-based revenue in order to subsidize its legacy generating assets violates Ohio law and policy. The PUCO's Order is unlawful, unreasonable, and should be reversed.

4. The prices resulting from PJM's Reliability Pricing Model represent the market price for capacity.

Ohio law requires the PUCO to ensure that generation is a competitive service and, therefore, to ensure that a utility's state compensation mechanism for capacity reflects market-based prices. PJM's RPM prices – the prices that AEP Ohio previously charged for years – are the best indicators of the market price for capacity. The RPM was specifically designed to replicate a competitive market and uses an auction process to establish a transparent price for capacity. *In re PJM Interconnection, LLC*, 121 FERC ¶ 61,173 at ¶ 13, n.20 and ¶ 24; Tr. Vol. II, p. 388; Supp. 9-10 [Stoddard Testimony]. It provides appropriate signals to capacity suppliers to make available sufficient resources to meet the forecast reliability requirements and, as found by the FERC, promotes just and reasonable prices for customers. *In re PJM Interconnection, LLC*, 121 FERC ¶ 61,173 at ¶ 49; Supp. 8-9. And all other capacity suppliers in the PJM territory receive RPM prices for their capacity. (*See* Supp. 21 [Stoddard Testimony].) Indeed, the use of RPM prices was overwhelmingly supported by the record testimony. (*See, e.g.*, Exelon Ex. 101 [Direct Testimony of David Fein], p. 6; Schools Ex. 101 [Direct Testimony of Mark Frye], p. 11.)

The PUCO's Staff also has testified in support of RPM prices, stating that “to the extent there is a transparent forward capacity price available in the market, such a price should be used,” (Staff Ex. 2, Direct Testimony of Hisham M. Choueiki (“Choueiki Testimony”), PhD, PE,

at pp. 4, 7-8⁸) and further that AEP Ohio's request to use cost-based rates was "not reasonable." (See Choueiki Testimony, pp. 4, 10; Tr. Vol. X, p. 1707 (Oct. 18, 2011).) The PUCO's authority to establish AEP Ohio's state compensation for capacity is limited to a market-based price, and the RPM prices are unquestionably that proper price. The PUCO's Order granting AEP Ohio additional revenue above the RPM price should be reversed.

5. The impropriety of the Order's guaranteed, cost-based revenues is even more striking as applied after AEP Ohio's corporate separation.

The PUCO's Order would allow AEP Ohio to receive the above-market, cost-based capacity revenue after AEP Ohio's corporate separation, which is planned for January 1, 2014. (Tr. Vol. I, pp. 32, 36.) The Order directs that the state compensation mechanism "shall remain in effect until AEP-Ohio's transition to full participation in the RPM market is complete and the Company is no longer subject to its FRR capacity obligations, which is expected to occur on or before June 1, 2015, or until otherwise directed by the Commission." (Appx. 50.) However, after AEP Ohio's corporate separation in 2014, AEP Ohio's competitive affiliate, AEP Generation Resources, will provide the capacity for non-shopping and shopping customers. Even if one assumes that the PUCO had the authority to apply traditional rate-based methodologies for the price for AEP Ohio's capacity under Revised Code Chapters 4905 and 4909, the PUCO has no authority as applied to AEP Generation Resources, which will not be a regulated utility. Chapters 4905 and 4909, Revised Code, cannot be said to apply to AEP Generation Resources – directly or indirectly through AEP Ohio – because the generation assets

⁸ This testimony was provided on Oct. 17, 2011 during the PUCO's hearing on AEP Ohio's ESP II Stipulation. AEP Ohio's capacity proceeding, Case No. 10-2929-EL-UNC, was consolidated with AEP Ohio's ESP II proceeding and several other proceedings by PUCO entry issued September 16, 2011. See *AEP ESP II*, Case Nos. 11-346-EL-SSO *et al.*, 2011 WL 6543006, at *2 (Opinion & Order Dec. 14, 2011).

on which the \$188.88/MW-day cost-based price is based will no longer be owned by AEP Ohio and no longer be subject to the PUCO's jurisdiction. *See* R.C. § 4909.15; *see also* R.C. §§ 4905.04, 4905.05, 4905.06.

AEP Generation Resources' receipt of the above-market, guaranteed capacity revenues would be a clear anti-competitive subsidy. As FES witness Dr. Lesser testified:

Because AEP Generation Resources will operate independently of AEP Ohio, there is no rational economic basis as to why AEP Ohio would agree to purchase capacity from AEP Generation Resources at an above-market price if it can purchase that capacity at a lower price in the market. In other words, buying capacity from AEP Generation Resources at an above-market price would be a cross-subsidy and a form of price discrimination.

(Supp. 109.) AEP Generation Resources must operate in the same competitive market as all other suppliers and, thus, must be subject to the same market price pressures. It has no right to guaranteed above-market revenues set by the PUCO.

C. Proposition of Law No. 3: The PUCO must follow the procedures set forth in Revised Code Chapter 4909 in order to set a cost-based rate for electric service.

The PUCO in its Order asserted that it had authority to set rates for AEP Ohio's capacity under Chapter 4909. (Appx. 48.) But, even assuming that to be true (which it is not), the PUCO was required to follow the procedures set forth in that Chapter. The PUCO failed to do so. Accordingly, the Order is unlawful and should be reversed.

1. Chapter 4909's requirements and procedures for setting an electric utility's rates are mandatory.

Chapter 4909 is the only statutory grant of authority to the PUCO regarding the establishment of a cost-based rate. *See* R.C. Ch. 4909. This Court has confirmed that the requirements of Chapter 4909 are mandatory for the PUCO in setting rates: "[T]he statutes of this state and the decisions of this court indicate that the [PUCO] must" adhere to the requirements of Chapter 4909. *City of Cleveland v. Pub. Util. Comm.*, 164 Ohio St. 442, 443,

132 N.E.2d 216 (1956) (citing requirements of R.C. §§ 4909.04, 4909.05, and 4909.15). The Court has further described the importance of the Chapter 4909 procedures as follows:

While the General Assembly has delegated authority to the [PUCO] to set just and reasonable rates for public utilities under its jurisdiction, it has done so by providing a detailed, comprehensive and, as construed by this court, mandatory ratemaking formula under R.C. 4909.15.

Columbus So. Power Co. v. Pub. Util. Comm., 67 Ohio St.3d 535, 537, 620 N.E.2d 835 (1993) (citing *Gen. Motors Corp. v. Pub. Util. Comm.*, 47 Ohio St.2d 58 (1976)) (emphasis added). The PUCO initially recognized that it was bound by the provisions of Chapter 4909 in proceeding to develop a cost-of-service rate for AEP Ohio's capacity service. (Appx. 48.) However, after parties argued in applications for rehearing that the PUCO did not adhere to all requirements of Chapter 4909, the PUCO turned its back on Chapter 4909. The PUCO stated that it had "no obligation with regard to the specific mechanism" and claimed that Section 4905.26, Revised Code, gives it all the authority it needs to set a cost-based rate for AEP Ohio's capacity service. (Appx. 99-100 [Oct. 17, 2012 Entry on Rehearing].) The PUCO's reversal of course is plainly contrary to established Ohio law.

Revised Code Chapter 4909 requires that, in establishing a cost-based rate, the PUCO must determine, among other things:

- The value of the utility's used and useful property as of a date certain;
- The dollar return applying the reasonable rate of return to the valuation of the property; and
- A cost-of-service analyses for a specified test period.

R.C. § 4909.15(C)(1). The PUCO essentially acknowledged that it did not follow the dictates of Chapter 4909 in connection with its determination of AEP Ohio's capacity rate. (Appx. 142-143 [Dec. 12, 2012 Second Entry on Rehearing].) Indeed, the PUCO made no findings regarding:

(1) the value of AEP Ohio's property; (2) a reasonable rate of return; or (3) a dollar rate of return. Nor is there anything in the record established a test period that conforms to the time limits set forth in the statute. See R.C. § 4909.15(C)(1) ("The utility may propose a test period for this determination that is any twelve-month period beginning not more than six months prior to the date the application is filed and ending not more than nine months subsequent to that date."). Given the absence of a test period, there was no determination made about AEP Ohio's costs during such test period.

If the PUCO's "traditional rate regulation" authority is the basis for its state compensation mechanism, then the PUCO must follow the requirements of Chapter 4909. The PUCO failed to adhere to that "detailed, comprehensive, and . . . mandatory ratemaking formula." *Columbus So. Power Co.*, 67 Ohio St.3d at 537. Accordingly, the PUCO's Order authorizing AEP Ohio to charge the cost-based equivalent of \$188.88/MW-day for capacity is unlawful and unreasonable, and must be reversed.

2. Revised Code Section 4905.26 does not authorize the PUCO to set a cost-based state compensation mechanism.

The PUCO justified its decision to ignore the procedures in Chapter 4909 by referring to its purportedly "considerable authority" to set a new utility rate under Section 4905.26, Revised Code. (Appx. 100 [Oct. 17, 2012 Entry on Rehearing].) In its Entries on Rehearing, the PUCO stated that its creation of the above-market state compensation mechanism was "consistent with Section 4905.26, Revised Code, as well as with our authority under Sections 4905.04, 4905.05, and 4905.06, Revised Code." (Appx. 80-81 [Oct. 17, 2012 Entry on Rehearing]; Appx. 142-143 [Dec. 12, 2012 Second Entry on Rehearing].) But Section 4905.26 simply allows the PUCO (or others) to initiate a proceeding to review rates. Once such proceedings are initiated, the actual authority to set specific new rates then must proceed under Chapter 4909.

Section 4905.26, Revised Code, provides that:

Upon complaint in writing against any public utility . . . , or upon the initiative or complaint of the public utilities commission, that any rate, fare, charge, toll, rental, schedule, classification, or service, . . . is in any respect unjust, unreasonable, unjustly discriminatory, unjustly preferential, or in violation of law, . . . if it appears that reasonable grounds for complaint are stated, the commission shall fix a time for hearing and shall notify complainants and the public utility thereof. The notice shall be served not less than fifteen days before hearing and shall state the matters complained of. The commission may adjourn such hearing from time to time. The parties to the complaint shall be entitled to be heard, represented by counsel, and to have process to enforce the attendance of witnesses.

Notably, Section 4905.26 is silent as to any authority to set a rate as a result of the hearing process. It is Chapter 4909 that sets the parameters and procedures for utility ratemaking. As this Court has explained, “R.C. Chapter 4905 governs the commission’s general power to regulate public utilities, while R.C. Chapter 4909 governs the commission’s power to set utility rates and charges.” *Indus. Energy Users-Ohio v. Pub. Util. Comm.*, 117 Ohio St.3d 486, 2008-Ohio-990, 885 N.E.2d 195, ¶ 28.

If Section 4905.26 gave the PUCO the authority to initiate an investigation and create any type of rate it so desired as a result of the hearing, then Chapter 4909 would be rendered meaningless. So, too, would this Court’s prior decisions holding that the Chapter 4909 procedures are “mandatory” in the PUCO’s development of electric rates. If the PUCO were correct, then any utility could side-step the rate-setting process in Chapter 4909 by initiating a proceeding under Section 4905.26. Utilities cannot do that. Neither can the PUCO. The PUCO’s broad construction of Section 4905.26 is supported by neither the express language of Section 4905.26 nor the statutory ratemaking framework.

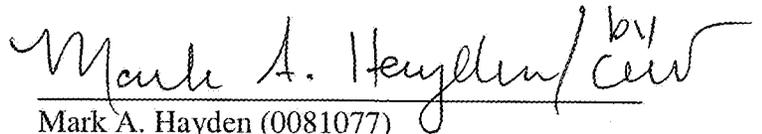
The PUCO’s reliance on Section 4905.26 as “authority” for its Order setting a state compensation mechanism is unlawful and unreasonable. Even if the PUCO were authorized to

set an above-market, cost-based rate for AEP Ohio's capacity, the Order should be reversed because the PUCO failed to follow the mandatory procedures for setting a cost-based rate.

IV. CONCLUSION

The PUCO's Order authorizing AEP Ohio to receive an above-market subsidy for its generating assets based on AEP Ohio's full embedded costs is inconsistent with the FERC-approved framework for capacity, violates Ohio law and policy, and fails to follow the mandatory ratemaking formula required by Ohio law. Thus, as set forth herein, the Court should reverse the PUCO's decision authorizing AEP Ohio to recover an above-market charge of \$188.88/MW-day for capacity.

Respectfully submitted,

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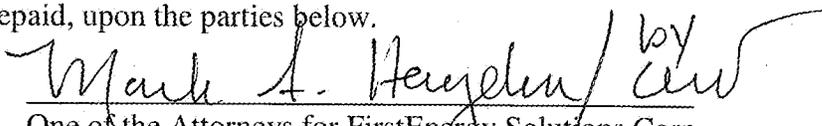
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CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing *Merit Brief of Appellant FirstEnergy Solutions Corp.*, including its Appendix and Supplement, was served this 15th day of July, 2013, via first-class U.S. mail, postage prepaid, upon the parties below.


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