ORIGINAL

IN THE SUPREME COURT OF OHIO

INDUSTRIAL ENERGY USERS – OHIO,	:	**Consolidated Case Nos. 2012-2098**
	:	**2013-0228**
Appellant,	:	
	:	**Appeals from the Public Utilities Commission of Ohio**
v.	:	
	:	
THE PUBLIC UTILITIES COMMISSION OF OHIO,	:	**Public Utilities Commission of Ohio Case No. 10-2929-EL-UNC**
	:	
Appellee.	:	

MERIT BRIEF AND APPENDIX OF APPELLEE/CROSS-APPELLANT OHIO POWER COMPANY

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AEP Ohio or the Company	**Ohio Power Company**
AEP Genco	**AEP Generation Resources**
AFR	**Application for Rehearing**
Br.	**Merit Brief**
Capacity Case	**PUCO Case No. 10-2929-EL-UNC**
***Capacity* Order**	**July 2, 2012 Opinion and Order in the *Capacity Case***
Commission or PUCO	**Public Utilities Commission of Ohio**
CRES provider	**Competitive Retail Electric Service Provider**
ESP	**Electric Security Plan**
ESP II	**PUCO Case Nos. 11-346-EL-SSO, *et al.***
***ESP II* Order**	**August 8, 2012 Opinion and Order in the *ESP II* case**
ETP	**Electric Transition Plan**
Exelon	**Exelon Energy Company, Inc., Exelon Generation, LLC, Constellation NewEnergy, Inc., and Constellation Energy Commodities Group, Inc.**
FERC	**Federal Energy Regulatory Commission**
FERC Order	**May 23, 2013 Order in FERC No. ER13-1164**
FES	**FirstEnergy Solutions Corp.**
FRR	**Fixed Resource Requirement**
IEU	**Industrial Energy Users – Ohio**
LSE	**Load Serving Entity**
MLR	**Member Load Ratio**
OCC	**The Office of the Ohio Consumers' Counsel**
OSS	**Off-System Sales**
PJM	**PJM Interconnection, LLC**
Pool	**AEP System Interconnection Agreement**
Prop.	**Proposition of Law**
RAA	**Reliability Assurance Agreement**
R.C.	**Revised Code**
Rehearing Entry	**October 17, 2012 Entry on Rehearing in the *Capacity Case***
RESA	**Retail Energy Supply Association**
RPM	**Reliability Pricing Model**
RTO	**Regional Transmission Organization**
Second Rehearing Entry	**December 21, 2012 Entry on Rehearing in the *Capacity Case***
SSO	**Standard Service Offer**

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INTRODUCTION

"Capacity" is not itself electricity, but rather the ability to provide electricity upon demand—in effect, the ability to keep the lights on even during periods of peak demand. AEP Ohio[1] is obligated to provide, and through May 2015 is the exclusive supplier of, capacity service sufficient to instantaneously satisfy the demands of all competitive providers in AEP Ohio's service territory. The State Compensation Mechanism (SCM) adopted by the Commission for providing that wholesale capacity service does not violate federal law. Rather, the federal tariff specifically provides that an SCM established by a state regulatory commission "prevails" over the default pricing regime advocated by Appellants. Indeed, the SCM adopted by the Commission was presented for approval by FERC, the federal agency responsible for enforcing the Federal Power Act, and FERC affirmatively endorsed the SCM as being "consistent with" the federal tariff.

The Commission properly exercised its broad authority under R.C. 4905.26 to investigate and modify the wholesale capacity rate; it was not required to follow the detailed, prescriptive process involved under the traditional ratemaking statute. The Commission's factual finding was that AEP Ohio's cost of providing wholesale capacity service is $188.88/MW-day. Despite Appellants' attack, the $188.88 rate is abundantly supported by record evidence. In fact, the rate is far too low, as demonstrated in AEP Ohio's cross appeal. Further, with respect to retail customers in AEP Ohio's service territory, only a cost "deferral" was authorized below. The deferral is only a preliminary step to cost recovery that is well within the Commission's broad authority and discretion over utility accounting; no retail ratemaking determinations were made below that as-

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[1] All of the acronyms and abbreviations used in this brief are contained in the Table of Acronyms and Abbreviations, *supra*, at viii.

sured AEP Ohio of recovery of its costs. Thus, Appellants' challenges to the details of how AEP Ohio will recover this cost under the Commission's order are premature and should be heard only in Case No. 2013-521 (where the Commission's subsequent ratemaking decision in a separate proceeding is being reviewed by this Court).

Appellants' other challenges merely demonstrate that they would have decided this complex and extensively litigated case differently if they were responsible for doing so—which they are not. The SCM adopted by the Commission promotes Ohio energy policy and equally addresses the interests of retail customers, wholesale competitors and AEP Ohio, in accordance with substantial Commission expertise and discretion this Court regularly acknowledges. Appellants' claims should be rejected. And the challenge of Appellee/Cross-Appellant AEP Ohio should be sustained.

STATEMENT OF FACTS

A. Regulatory Background

AEP Ohio participates as a Load-Serving Entity (or "LSE") in a 13-state capacity market run by PJM. 134 FERC ¶ 61,039, at P4 (2011), Supp. at 806.[2] Under PJM's Reliability Assurance Agreement (or "RAA"), LSEs like AEP Ohio must have, or contract for, sufficient capacity to provide reliable service to their end-use customers. *Id.* at PP2-4. LSEs can meet that obligation by participating in an annual PJM capacity auction that uses PJM's pricing model (called "RPM"). 137 FERC ¶ 61,108, at P6 (2011). Or they can invoke "an alternative method for meeting the RPM capacity obligation, the Fixed Resource Requirement (FRR)." 134 FERC ¶ 61,039,

[2] PJM is a Regional Transmission Organization, or "RTO." RTOs are federally regulated entities responsible for overseeing the interstate delivery of electricity to support competitive bulk energy markets. 89 FERC ¶ 61,285, at 61,151-52 (1999). RTOs manage regional transmission grids, offering non-discriminatory access to energy suppliers.

at P2, Supp. at 806. FRR Entities must submit a plan to meet the capacity requirement with specific resources. *Id.*

Competitive Retail Electric Service providers ("CRES providers") that sell electricity to customers must also ensure the availability of sufficient capacity for them. In Ohio, CRES providers obtain capacity only from AEP Ohio. Section D.8 of Schedule 8.1 of PJM's RAA addresses compensation for providing capacity:

> In the absence of a state compensation mechanism, the applicable [CRES provider] shall compensate the FRR Entity at the capacity price in the unconstrained portions of the PJM Region, as determined in accordance with Attachment DD to the PJM Tariff, provided that the FRR Entity may, at any time, make a filing with FERC under Section 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 . . . [.]

134 FERC ¶ 61,039, at PP2-3, quoting RAA Section D.8, Supp. at 806. Section D.8 thus establishes a hierarchy of compensation mechanisms. If there is a state compensation mechanism (an "SCM"), it controls. If there is not, an FRR Entity like AEP Ohio is compensated at the price set by PJM's auction, unless it seeks a cost-based (or other just and reasonable) mechanism before FERC. *Id.* at P4.

B. Proceedings Before FERC

When PJM introduced RPM capacity auctions in 2007, AEP Ohio received capacity compensation from CRES providers based on RPM prices. 134 FERC ¶ 61,039, at P4, Supp. at 807. Since then, auction prices (*i.e.*, the RPM clearing price) have fallen far below AEP Ohio's actual cost of supplying capacity. *Id.* AEP Ohio thus requested that FERC change the basis for capacity compensation from the auction price to a cost-based price. *Id.*

The Commission then represented to FERC that it had "adopted the use of the RPM auction price as its state compensation mechanism" for providing capacity to CRES providers. 134

FERC ¶ 61,039, at P6, Supp. at 808. Because Schedule 8.1 of the RAA provides that a party may seek a FERC-approved rate schedule "*in the absence* of" an SCM, *id.* at P10 (emphasis added), FERC rejected AEP Ohio's filing, citing "the existence of" an SCM. *Id.* at P13.

C. Proceedings Before The Commission

The Commission issued an order requesting comments on the effects of adopting the RPM auction price as an SCM. *See* Entry (Dec. 8, 2010), IEU Appx. at 182-84. After extensive briefing and testimony, the Commission issued the decision appealed here—the *Capacity* Order—on July 2, 2012. *See Capacity* Order, IEU Appx. at 45-89.

1. The Commission's Determination of Jurisdiction

The Commission first addressed whether it had jurisdiction to establish an SCM. *Id.* at 9, IEU Appx. 53. Because "Sections 4905.04, 4905.05, and 4905.06, Revised Code, grant the Commission authority to supervise and regulate [all] public utilities within its jurisdiction," the Commission concluded that it has the necessary statutory authority to do so. *Id.* at 12, IEU Appx. at 56. The Commission rejected IEU's contention that the capacity AEP Ohio provides CRES providers is a competitive retail electric service exempt from the Commission's authority under R.C. 4905.04, 4905.05, and 4905.06. *Id.* at 13, IEU Appx. at 57. It determined that AEP Ohio's provision of that capacity "is not a retail electric service as defined by Ohio law." *Id.*

Retail electric service is limited to 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.' " (Emphasis added.) *Id.*, quoting R.C. 4928.01(A)(27). The capacity at issue here, by contrast, "is provided by AEP Ohio *for CRES providers*," which are not energy consumers but entities that provide electricity to consumers. (Emphasis added.) *Id.* That transaction, the Commission concluded, "is more appropriately characterized as an intrastate wholesale matter," not retail electric service. *Id.* The Commission also ruled that exercising jurisdiction, for the purpose of establishing an appropriate SCM, is consistent with the governing section of the RAA, which, as a part of PJM's tariffs, has been approved by FERC and accepted by AEP Ohio. *Id.*

2. The Commission's Cost-Based State Compensation Mechanism

The Commission then turned to whether the SCM for AEP Ohio should be based on costs or on "another pricing mechanism such as RPM-based auction prices." *Capacity* Order at 9, IEU Appx. at 53. AEP Ohio urged that, because it self-supplies capacity from its own plants to meet load obligations, its cost of providing capacity to CRES providers is "the actual embedded capacity cost of AEP Ohio's generation." (AEP Ohio Ex. 102 at 5, Supp. at 29.) It showed that an auction-based rate, by contrast, would not allow it to recover costs. "[T]he current capacity pricing mechanism undercompensates AEP Ohio for the capacity it provides to CRES providers." (AEP Ohio Ex. 101 at 8, Supp. at 8.) The auction-based rate would have led to a $240 million decrease in AEP Ohio's revenue in 2012 and 2013 alone. (Tr. III at 701:14-17, Supp. at 582.)

Auction prices, moreover, have fluctuated wildly with no relation to cost. Starting at $174.29/MW-day for capacity provided in 2010/2011, the auction price cratered to less than 10 percent of that, or $16.46/MW-day for capacity provided in 2012/2013, before partially recovering to $125.99/MW-day for 2014/2015. (AEP Ohio Ex. 102 at Ex. KDP-7, Supp. at 211.) The tendency of prices to fluctuate dramatically, while remaining well below the cost of a new combined-cycle unit, was contrary to the goal of capacity requirements—ensuring availability of resources and development of new ones to meet peak demand. Such fluctuating and sub-cost compensation provides "little or no incentive to invest in Ohio asset generation." (AEP Ohio Ex. 101 at 9, 12, 14, Supp. at 9, 12, 14; *see also* Tr. I at 43, Supp. at 577.) Unlike short-term RPM-based pricing, cost-based compensation "represents a long-term view of affordable and reliable capacity for Ohio customers," (AEP Ohio Ex. 101 at 10, Supp. at 10), that "adequately compensates the Company for its capacity obligations as an FRR Entity." *Capacity* Order at 15, IEU Appx. at 59; (AEP Ohio Ex. 101 at 14, Supp. at 14.)

The Commission agreed with AEP Ohio that it is both necessary and appropriate to establish a cost-based SCM for capacity. *Capacity* Order at 22, IEU Appx. at 66. The rates at auction for capacity, the Commission found, had decreased to "substantially below all estimates provided by the parties regarding AEP Ohio's cost of capacity." *Id.* at 22-23, IEU Appx. at 66-67. RPM-based capacity pricing thus would be "insufficient to yield reasonable compensation." *Id.* at 23, IEU Appx. at 67. The Commission nonetheless decided that maintaining auction-based prices for CRES providers "will promote retail electric competition," and found it necessary to take "appropriate measures to facilitate this important objective." *Id.* The Commission thus directed AEP Ohio to collect the auction rate from CRES providers and "defer incurred capacity costs not recovered from CRES provider billings." *Id.* The Commission chose to address from whom the deferred capacity costs would be recovered, and how, in the separate *ESP II* proceeding.

3. The $355.72/MW-Day Capacity Cost Estimate and Subsequent Reduction to $188.88/MW-Day

With respect to the amount of compensation, AEP Ohio showed that the cost of providing capacity was $355.72/MW-day. *Capacity* Order at 24-25, IEU Appx. at 68-69. AEP Ohio's expert testified that AEP Ohio's formula incorporated the average cost of providing capacity on a dollar-per-MW-day basis. *Id.* at 24, IEU Appx. at 68. The formula was modeled after one FERC had recently approved for wholesale capacity charges elsewhere. (AEP Ohio Ex. 102 at 9, Supp. at 11.) That FERC-approved method is based on common cost allocation mechanisms providing a "high degree of transparency" because the bulk of the information comes from an annual filing with FERC. (*Id.*) And it is easily updated "using the next year's accounting information." (*Id.*)

AEP Ohio also addressed Staff's proposal for an "energy credit." AEP Ohio explained that, under its model, its costs were already allocated between capacity and other revenue-generating activities; AEP Ohio thus was not recovering costs associated with other profitable activities through capacity charges. AEP Ohio explained that, if an energy credit was imposed, it should be the difference between market-based revenues from those other activities and AEP Ohio's energy cost. (AEP Ohio Ex. 102 at 14, Supp. at 16.) Thus, any energy credit should reflect "actual energy margins"—not the unrealistically high imputed profit advocated by Staff. *Capacity* Order at 28, IEU Appx. at 72. AEP Ohio's expert testified that a $17.56/MW-day energy offset "represents a fair and reasonable proxy for the energy revenue that could have been obtained * * * by selling equivalent generation into the market rather than utilizing it to directly serve load." (AEP Ohio Ex. 102 at 15 & Ex. KDP-6, Supp. at 17, 209.) The Commission, however, adopted Staff's approach, with minor adjustments to correct for mistakes in Staff's analysis, finding that Staff's proposed offset for energy-related sales—totaling a significant portion of costs—is necessary to ensure that AEP Ohio does not "over recover its capacity costs." *Capacity* Order at 33-34, IEU Appx. at 77-78.

4. Further Proceedings

a. Mandamus Proceedings Before This Court

In August 2012, IEU filed a complaint for writs of prohibition and mandamus, challenging the Commission's jurisdiction. *See* Complaint, Case No. 2012-1494 (Aug. 31, 2012). On April 16, 2013, this Court granted AEP Ohio's and the Commission's motions to dismiss.

b. Proceedings Before the Commission on Rehearing

On October 27, 2012, the Commission granted rehearing, in part. It explained that R.C. 4905.26 grants the Commission "considerable authority" to investigate and "review rates." Rehearing Entry at 29, IEU Appx. at 118. The Commission found that it "properly initiated this proceeding, consistent with that statute, to examine AEP Ohio's existing capacity charge for its FRR obligations and to establish an appropriate [SCM]." *Id.* It thus granted rehearing to clarify that the *Capacity* Order was issued in accordance with the Commission's authority in R.C. 4905.26, along with its general supervisory powers pursuant to R.C. 4905.04, 4905.05, and 4905.06. *Id.* The Commission denied rehearing in all other respects.

c. Additional Proceedings Before FERC

In March 2013, AEP Ohio filed with FERC a proposed appendix to the PJM RAA, specifying the wholesale charges to be assessed under Schedule 8.1 of Section D.8 of the RAA. FERC No. ER13-1164, Application, at 1 (Mar. 25, 2013), Supp.at 810. FERC accepted the proposed Appendix (as amended), explaining that the SCM approved by the Commission is "consistent with the RAA." FERC Order at ¶ 26, Supp. at 842.

LAW AND ARGUMENT

AEP OHIO'S RESPONSE TO APPELLANTS' PROPOSITIONS OF LAW

<u>Proposition of Law No. I</u>: The Commission's ruling does not conflict with FERC tariffs. [FES Prop. I; IEU Prop. III]

FES challenges the Commission's establishment of cost-based compensation as contrary to the FERC-approved RAA tariff. (FES Br. at 19-26.) Similarly, IEU contends that "[t]he Commission does not have jurisdiction to interpret and apply the RAA, a FERC-approved agreement." (IEU Br. 31.) Those arguments are not properly before this Court and, in any event, lack merit. The federal tariff expressly allows for the establishment of an SCM, but nowhere limits States to particular methodologies. And the tariff itself contemplates the use of RPM (auction) *or* cost-based rates in the absence of an SCM.

A. FES's and IEU's tariff-based challenges are not properly before this court.

As explained in greater detail in AEP Ohio's July 16, 2013 Amended Motion To Dismiss (pp. 12-19), FES Prop. I and IEU Prop. III impermissibly challenge FERC's May 23, 2013 Order. *See* FERC Order at ¶ 26, 30, Supp. 841-42. After the Commission issued its orders, AEP Ohio filed with FERC a proposed conforming appendix to the federal tariff (RAA) with FERC, seeking confirmation that the SCM conforms with the RAA and federal law. FERC No. ER13-1164, Application, at 1 (Mar. 25, 2013), Supp. at 810. FERC confirmed that the proposed Appendix, as amended, "accords with the RAA and the [SCM]." *Id.* If FES and IEU disagree, their sole remedy was to seek rehearing before FERC and review in federal court. *See* 16 U.S.C. § 825*l*(b).

Although FES may contend that FERC's ruling was limited to approving payment of RPM rates by CRES providers—and excluded the recovery from other sources—the approved Appendix refers to the SCM *generally*, not piece-parts thereof. It says that, "on July 2, 2012, [the Commission] issued an order approving *a state compensation mechanism* for load of [CRES providers] in [AEP Ohio's] FRR Service Area for FRR capacity made available by [AEP Ohio] under the RAA." (Emphasis added.) FERC Order at ¶ 12, Supp. at 838.[3] And FERC held that the

[3] The record is clear that the "state compensation mechanism" FERC referenced included AEP Ohio's recovery of capacity costs through both RPM (auction) rates *and* from other sources. The Commission's July 2 order itself "adopt[ed] a cost-based state compensation mechanism for AEP Ohio, with a capacity charge of $188.88/MW-day, in conjunction with the authorized deferral of the Company's incurred capacity costs." *Capacity* Order at 36. AEP Ohio's filings thus explained that the "state compensation mechanism" before FERC had two components, stating that

Capacity Order, which approved an SCM, is "consistent with the RAA." *Id.* ¶ 26, Supp. at 928. FES and IEU now ask this Court to reach the opposite conclusion by overturning one component of the SCM as inconsistent with the RAA. But any disagreement with FERC's contrary conclusion had to be raised on rehearing with FERC and through federal judicial review; FERC's resolution cannot be collaterally attacked here.

FES's and IEU's arguments are also foreclosed by claim preclusion, which "prevents subsequent actions, by the same parties or their privies, based upon any claim arising out of a transaction that was the subject matter of a previous action." *State ex rel. Schachter v. Ohio Pub. Emps. Ret. Bd.*, 121 Ohio St.3d 526, 2009-Ohio-1704, 905 N.E.2d 1210 ¶ 27. Claim preclusion applies not merely to issues actually raised in the prior proceeding, but also to any issue that *could have been* raised. *Id.* And the doctrine applies to quasi-judicial administrative proceedings as well as prior judicial proceedings. *Id.* ¶ 29. When AEP Ohio filed the proposed amendment to the RAA with FERC, FES and IEU had every chance to tell federal regulators that the Commission's order conflicts with tariffs, like the RAA, that are within FERC's jurisdiction. They did not. They thus may not raise those arguments now.

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the "mechanism . . . is designed by the Ohio Commission to allow [AEP Ohio] to recover the cost of making capacity available . . . *through a combination of wholesale charges to CRES providers and retail charges to [AEP-Ohio's] retail distribution customers*." AEP Ohio FERC filing at 1-2 (emphasis added), Supp. at 896-97; *see also id.* at 7, Supp. at 902 ("The Ohio Commission decided that [AEP Ohio] should recover its capacity costs for shopping load through a two-part mechanism."). AEP Ohio specifically urged FERC "to confirm" the Commission's "adoption of a state compensation mechanism with wholesale and retail components")." *Id.* at 2, Supp. at 897. And FERC understood that: In its orders, it declares that AEP Ohio and the Ohio Commission had clarified they "[we]re requesting one limited ruling that the Ohio Commission's decision to adopt a *two-part state compensation mechanism* is fully consistent with the RAA." FERC Order ¶ 19 (emphasis added), Supp. at 840.

Finally, FES's and IEU's arguments are foreclosed by FERC's supremacy on the meaning of FERC tariffs. As explained in AEP Ohio's July 16, 2013 Amended Motion To Dismiss (at p. 19), "FERC, not the state, is the appropriate arbiter of any disputes involving a [federal] tariff's interpretation." *AEP Tex. N. Co. v. Tex. Indus. Energy Consumers*, 473 F.3d 581, 585 (5th Cir. 2006). If FES and IEU believe that AEP Ohio's rate, as set by the Ohio Commission, violates a federal tariff, they must file a complaint with FERC under 16 U.S.C. § 825*l*(b). The proper construction of the federal tariff is an issue for FERC.

B. FES misreads the federal tariff.

FES never bothered pressing its construction of the RAA with FERC, and for good reason: It has no basis in the RAA's text or purpose. According to FES, the RAA limits States adopting an SCM to what FES calls an "avoided cost" model, which offers only the "minimum level" of compensation "necessary to keep [capacity-generating] facilities operating"—and thus no compensation for investment in those facilities and no incentive to invest in new facilities. (FES Br. 20.) But the RAA declares only that, "*[i]n the absence of [an SCM]*, the applicable [CRES provider] shall compensate the FRR Entity" at certain rates (either the RPM auction rate or, in the alternative, any just-and-reasonable cost-based rate approved by FERC). Nothing in the RAA limits States to particular methodologies or rates. And nothing imposes the "avoided cost" methodology FES posits as exclusive.

To the contrary, the RAA expressly contemplates various methodologies. Absent an SCM, payment can be based on the RPM rate. 134 FERC ¶ 61,039, at 2-3, Supp. at 807-08. Or an FRR Entity like AEP Ohio can "propos[e] to change the basis for compensation to *a method based on the FRR Entity's costs*." (Emphasis added.) *Id.*, quoting Section D.8. Or it can propose any "*such other basis* shown to be just and reasonable." (Emphasis added.) *Id.* FES cannot explain how the RAA allows that variety of methodologies to FERC absent an SCM, but forbids them to States that establish SCMs. In any event, if the only permissible cost-based methodology were "avoided cost," the RAA would not authorize FERC to adopt "*a method* based on the FRR Entity's costs"; it would require "a method based on the FRR Entity's *avoided* costs." The RAA's failure to include the word "avoided" speaks volumes.

FES argues that one of the drafters of the RAA (FES's paid expert) testified that his "view of it as [the RAA] was written" was that "we were talking just about avoidable costs." (FES Br. at 21-22.) But the RAA does not say that; its expert cannot speak to what other drafters thought; and there is no evidence FERC understood that in approving the RAA. At no point, moreover, were States put on notice of any intent to foreclose them from using traditional methodologies like fully allocated costs. FES also overlooks contrary testimony that the RAA "was drafted to ensure that FRR entities could request a cost-based method *of recovering their cost* [of] capacity." (AEP Ohio Ex. 101 at 5, Supp. at 5.) If the RAA's drafters and FERC had intended to limit States by foreclosing a traditional compensation methodology in favor of FES's "avoided cost" methodology, the tariff would say so. At bottom, the RAA says only one thing about SCMs: Where one exists, it controls. FES's theory that the RAA silently stripped States of their authority to determine appropriate compensation using standard methodologies is unsupported. And FES's theory that the RAA mandates departure from traditional methodologies in favor of its proposal—avoided costs—is invented from whole cloth.

C. FES's avoided cost mechanism defies basic economics.

FES's argument that the RAA requires use of its avoided-cost methodology fails on the RAA's text alone. Here, moreover, the Commission used a traditional (if not *the* traditional) means of determining compensation—compensating a utility for the fully allocated cost of providing service. The Commission thus found it "reasonable" for the SCM to base AEP Ohio's compensation on its costs. *Capacity* Order at 22, IEU Appx. at 66. By contrast, "RPM-based capacity pricing would be insufficient to yield reasonable compensation for AEP Ohio's provision of capacity to CRES providers." *Id.* at 23, IEU Appx. at 67. Recoverable costs must include the recovery of fixed costs—the costs of building plants—that FES's avoided-cost methodology excludes.

D. IEU's argument regarding the Commission's authority to interpret the RAA is incorrect.

The Commission also correctly rejected IEU's argument that the Commission lacks jurisdiction to interpret and apply the RAA. The RAA states that it applies only in the absence of an SCM. 134 FERC ¶ 61,039, at 2-3, Supp. 807-08. Here, the *Capacity* Order establishes an SCM. Because the RAA expressly authorizes SCMs, it makes no sense to urge—as IEU does—that the RAA constrains the ability of the Commission to establish a cost-based SCM. Nor does it make any sense to argue that the Commission cannot interpret the RAA merely because it is a contract. (IEU Br. 31-32.) IEU cites cases holding that the Commission cannot "adjudicate controversies between parties as to contract rights," or "determine legal rights and liabilities." (*Id.* at 31.) But those cases do not involve contracts *filed and approved as regulatory tariffs*. IEU's position would preclude the Commission and this Court from reviewing every agreement by parties filed with the Commission as a stipulation. That is obviously not the law; this Court routinely adjudicates stipulations filed with the Commission. *See, e.g.*, *Constellation NewEnergy, Inc. v. Pub. Util. Comm.*, 104 Ohio St.3d 530, 2004-Ohio-6767, 820 N.E.2d 885, ¶ 49. IEU's arguments to the contrary should be rejected.

<u>Proposition of Law No. II</u>: The Commission has authority to establish an SCM directing AEP Ohio to continue to charge CRES providers like FES a market-based, RPM price for capacity based on the RPM auction. [FES Prop. II]

FES raises five challenges to the Commission's authority. None has merit. The price the Commission established for AEP Ohio to charge CRES providers is *the RPM price that FES itself advocated in the underlying proceeding*. And any challenge to the Commission's cost deferral should be addressed in the Company's *ESP II* case, where rate recovery issues were decided; FES's attempts to challenge the deferrals in this case are premature. *See* Prop. V.A, pp 30-32, *infra*. They are, in any event, unmeritorious.

A. The capacity AEP Ohio supplies to CRES providers is not "competitive retail electric service" and does not produce "transition revenue."

FES contends that the wholesale capacity service that AEP Ohio provides to competitive suppliers is a "competitive retail generation service" under Ohio law, and that generation assets are not subject to cost-of-service regulation. (FES Br. at 26-29.) The Commission properly concluded that capacity service is not a "retail electric service" at all. *Capacity* Order at 13, IEU Appx. at 57; *see* Prop. III.C, *infra*. AEP Ohio's capacity service, moreover, is plainly not competitive: It is provided by only one entity in the market (AEP Ohio, given its FRR status) and thus is the antithesis of a "competitive" service. Indeed, no party below even challenged the facts underlying Commissioner Roberto's conclusion in her concurring opinion that the wholesale capacity service at issue is noncompetitive. *Capacity Case*, July 2, 2012 Concurring and Dissenting Opinion of Commissioner Cheryl L. Roberto, at 2, IEU Appx. at 87.

While acknowledging that the transition to a fully competitive market "has not been an easy one," FES mischaracterizes the SCM as impermissibly giving AEP Ohio transition revenues. (FES Br. at 27-28.) But establishing a wholesale capacity price does not involve the retail generation transition charges addressed by R.C. 4928.40—which were applicable only from 2001-2005 and which the Company agreed to forgo as part of the settlement of its electric transition plan proceeding (PUCO Case No. 99-1729-EL-ETP, *et al.*). This proceeding involves establishing a *wholesale* capacity price given AEP's status as a wholesale FRR supplier. The issue of whether AEP Ohio could recover stranded asset value from retail customers is distinct from establishing a wholesale capacity price that permits AEP Ohio's competitors to use its capacity. Besides, any assertion that AEP Ohio cannot recover its capacity costs through a wholesale rate would conflict with the FERC-approved RAA and be preempted under the Federal Power Act.

The Commission properly rejected the "improper transition cost" argument. It explained that "transition costs are retail costs that, among meeting other criteria, are directly assignable or allocable to retail electric generation service provided to electric consumers in this state." Rehearing Entry at 19, IEU Appx. at 108. AEP Ohio's provision of capacity to CRES providers, by contrast, "is not a retail electric service" because it "is not provided directly by AEP Ohio to retail customers, but is rather a wholesale transaction between the Company and CRES providers." *Id.* at 19-20, IEU Appx. at 108-109. Thus, "[b]ecause AEP Ohio's capacity costs are not directly assignable or allocable to retail electric generation service," the Commission correctly determined that they are "not transition costs by definition." *Id.* at 20, IEU Appx. at 109.

This Court should also reject FES's misguided claim. The Commission's establishment of an SCM requiring CRES providers to pay RPM prices is not an impermissible attempt to secure transition revenues or abuse market power. Given that CRES providers such as FES will pay AEP Ohio a market-based price for capacity pursuant to the Commission's orders, it is an appropriate step in promoting the competitive market contemplated by the General Assembly.

B. Capacity is not a "retail concept."

FES complains that AEP Ohio's capacity service cannot be a "wholesale" service outside the scope of R.C. 4928.01(A)(27) because, according to FES, "capacity is a retail concept in Ohio." (FES Br. at 29-32.) But the Commission correctly determined that the capacity service at issue here is not a retail electric service. It is "more appropriately characterized as an intrastate wholesale matter between AEP Ohio and each CRES provider operating in the Company's service territory." *Capacity* Order at 13, IEU Appx. at 57. As explained below (Prop. III.C.1, *infra,* at 22-23), that conclusion is unassailable: AEP Ohio provides that service to CRES providers—not to retail ratepayers.

FES next argues that R.C. 4928.02, 4928.12, 4928.17, and 4928.37-.40 "would be rendered mere surplusage" by the Commission's interpretation of the phrase "retail electric service" in R.C. 4928.01(A)(27). (FES Br. at 29.) FES does not explain why this is so. In any event, the Commission's orders are consistent with the policies enumerated in R.C. 4928.02 and do not render any of them "mere surplusage."[4] FES cites three statutes in support of its contention that "Ohio law makes sparse mention of capacity, but when it does it unites capacity with energy as the retail product sold to consumers." (FES Br. at 31, citing R.C. 4928.142(C), 4928.143(B)(2)(a), and 4928.20(J).) But all three of those statutes are found in the Chapter of the Revised Code concerning *competitive retail* electric service, and the wholesale capacity service sold to CRES providers is *neither* competitive *nor* retail.

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[4] In its Post-Hearing Briefs filed with the Commission, AEP Ohio discussed how a cost-based capacity rate advances State policy objectives, including the policy to "[e]nsure the availability to consumers of adequate, reliable, safe, efficient, nondiscriminatory, and reasonably priced retail electric service." R.C. 4928.02(A). (*See* AEP Ohio Initial Post-Hearing Br. at 16-22 (May 23, 2012), Supp. at 620-26; AEP Ohio Reply Post-Hearing Br. at 7-12 (May 30, 2012), Supp. at 311-16.) FES takes issue with none of those showings.

C. The Commission properly considered the Company's return-on-equity projections in support of its Orders.

As the Commission noted in its July 2 Order, the auction rate then in effect was "substantially below all estimates provided by the parties regarding [AEP Ohio's] cost of capacity." *Capacity* Order at 23, IEU Appx. at 67. If RPM-based capacity pricing were adopted, the Commission found, Ohio "may earn an unusually low return on equity of 7.6 percent in 2012 and 2.4 percent in 2013, with a loss of $240 million between 2012 and 2013." *Id.* FES argues that, in calculating AEP Ohio's anticipated return on equity, the Commission looked to "returns on equity for its combined operations—distribution and generation." (FES Br. at 32). That, FES complains, "violates the separation mandate of Section 4928.17, Revised Code." *Id.*

That complaint misses the mark. For the two years relevant to these projections (2012-2013), the generating assets included in the equity projections were still owned by AEP Ohio and had not yet been separated into assets of AEP Genco. And even after corporate separation, the capacity and energy from the same generation plants used to serve the non-shopping customers remained committed based on a FERC-approved contract between AEP Ohio and its generation affiliate to continue support of the standard service offer through 2015. The U.S. Supreme Court has held that public utility companies must be compensated for the costs incurred in providing service. *FERC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n. of W.Va.*, 262 U.S. 679 (1923). And the rate AEP Ohio will pay for capacity service after corporate separation will be $188.88/MW-day. As such, it was entirely proper for the Commission to rely on that evidence.

D. FES's focus on the benefits of RPM ignores that the Commission directed AEP Ohio to continue to charge RPM prices.

FES also argues that RPM prices are "the best indicators of the market price for capacity" and "overwhelmingly supported by the record testimony." (FES Br. at 33.) Given that the Commission *did* direct AEP Ohio to charge CRES providers the RPM price for capacity, FES's argument fails. And although FES contends that the "Order granting AEP Ohio additional revenue above the RPM should be reversed" (*id.*), there are two fundamental flaws in that argument. First, as a CRES provider paying only RPM prices for capacity under the Commission's orders, FES is not harmed and should not be permitted to complain about *other* charges paid *not by FES* but by others because it does not have a personal stake in the outcome of the controversy. *Senior Citizens Coalition v. Pub. Util. Comm.*, 40 Ohio St.3d 329, 533 N.E.2d 353 (1988); *Fed. Home Loan Mortg. Corp. v. Schwartzwald*, 134 Ohio St.3d 13, 2012-Ohio-5017, 979 N.E.2d 1214, ¶¶ 21-23. Second, FES's challenge of the deferral for costs above the RPM level should not be heard here. Finally, the arguments lack merit as explained below (Prop. V, *infra* at 32-39).

E. AEP Ohio's planned corporate separation does not render the Commission's Orders unreasonable or unlawful.

FES also complains that the Commission's orders are improper in light of AEP Ohio's planned corporate separation by the end of 2013. (FES Br. at 34-35.) FES contends that, even if the Commission had authority to establish an SCM for AEP Ohio, it has no authority to do so for AEP Genco, because the generation assets on which the $188.88/MW-day price is based will no longer be owned by AEP Ohio. (*Id.*) Quoting its own witness, FES posits that AEP Genco's receipt of "above-market, guaranteed capacity revenues would be a clear anti-competitive subsidy" and "'form of price discrimination.'" (*Id.* at 35.) Those contentions lack merit.

FES advanced the same arguments in contesting the *ESP II* decision and FES is advancing the same arguments on appeal from that case.[5] The arguments are meritless. Generation revenues appropriately follow the generation assets from AEP Ohio to AEP Genco, particularly since AEP Genco will operate those assets to support the SSO. The assets being transferred continue to be committed to utility service; that use requires financial compensation. The revenues simply allow AEP Ohio to pay AEP Genco for capacity to meet its FRR commitment pursuant to a FERC-approved power supply agreement. Without the revenues, AEP Genco needed such assurances in order to proceed with the transaction. FES's misguided arguments regarding AEP Ohio's planned corporate separation should be rejected, as the Commission properly did in the *ESP II* case.

Proposition of Law No. III: The Commission correctly rejected IEU's challenges to the Commission's jurisdiction to establish an SCM and OCC's overly restrictive interpretation of jurisdiction under R.C. 4905.26. [IEU Prop. I and Prop. II; OCC Prop. I]

IEU challenges the Commission's jurisdiction, arguing that capacity service is a competitive retail electric service that the Commission may only regulate under R.C. 4928.141 through 4928.144. (IEU Br. at 19-28.) According to IEU, the Commission may not rely on R.C. Chapters 4905 and 4909 to establish an SCM. (*Id.* at 29-31.) Relatedly, OCC claims the Commission lacked authority under R.C. 4905.26 because it allegedly failed to follow certain procedural requirements. (OCC Br. at 13-19.) Those challenges all fail.

The Commission found "reasonable grounds" existed to initiate and pursue the investigation into AEP Ohio's capacity charges, consistent with its authority under R.C. 4905.26:

[5] FES has included the argument in its May 28, 2013 Notice of Appeal in the *ESP II* case, S.Ct. Case No. 2013-521, and in its *ESP II* Merit Brief (at pp. 30-33).

> We believe that the Initial Entry provided sufficient indication of the Commission's finding of reasonable grounds for complaint that AEP-Ohio's capacity charge may be unjust or unreasonable. We agree with AEP-Ohio that there is no precedent requiring the Commission to use rote words tracking the exact language of the statute in every complaint proceeding. In any event, to the extent necessary, the Commission clarifies that there were reasonable grounds for complaint that AEP-Ohio's proposed capacity charge may have been unjust or unreasonable.

Second Rehearing Entry at 9, FES Appx. at 144. The Commission is correct that its jurisdiction does not turn on whether it recites a specific phrase at a particular stage of the proceeding; rather, it is based on whether the substantive nature of its actions are based on law and the record. As this Court has found, the Commission has considerable authority under R.C. 4905.26 to initiate proceedings to investigate the reasonableness of any rate or charge and impose new utility rates or change existing rates of a public utility. *Consumers' Counsel v. Pub. Util. Comm.*, 110 Ohio St.3d 394, 2006-Ohio-4706, 853 N.E.2d 1153, ¶¶ 29, 32. *See, e.g., Allnet Communications Servs., Inc. v. Pub. Util. Comm.*, 32 Ohio St.3d 115, 117, 512 N.E.2d 350 (1987) ("R.C. 4905.26 is broad in scope as to what kinds of matters may be raised by complaint before the PUCO.) The Commission properly asserted jurisdiction over this case based on R.C. 4905.26 and the Appellant's jurisdictional challenges should be rejected.

A. The Commission's determination of its own jurisdiction is entitled to deference.

This Court has long deferred to the Commission's determination of its own jurisdiction. *E.g., State ex rel. Cleveland Elec. Illuminating Co. v. Pub. Util. Comm.*, 173 Ohio St. 450, 452, 183 N.E.2d 782 (1962). The U.S. Supreme Court recently confirmed that an agency's interpretation of a statutory ambiguity concerning the scope of its regulatory authority is entitled to deference. *City of Arlington v. FCC*, 133 S. Ct. 1863, 1871-1872 (2013). IEU's jurisdictional challenges must be reviewed through this deferential lens.[6]

B. The factual premise of IEU's jurisdictional challenges is inaccurate.

As a preliminary matter, IEU posits that the Commission "is prohibited from . . . applying cost-based ratemaking principles" (IEU Merit Br. at 19) "to increase the capacity-related compensation that AEP Ohio receives from CRES providers." (*Id.* at 29.) But in the final decision the Commission's orders did not change the rate that CRES providers paid for capacity prior to commencement of the investigation. Rather, the Commission directed AEP Ohio to *continue* to charge CRES providers the RPM price. *Capacity* Order at 23, IEU Appx. at 67. The very premise of IEU's jurisdictional challenges, which is that the Commission improperly "increased" the price for capacity that AEP Ohio provides to CRES providers, is incorrect. (IEU Merit Br. at 29). In fact, the RPM rate is now *lower* than it was when the *Capacity Case* began. In light of the deference due an agency's jurisdictional determinations, this Court should hesitate to question the Commission's authority to act where the challenging party mischaracterizes the nature of the action actually taken.

C. Appellants mischaracterize the capacity service as a competitive retail—not wholesale—service, misinterpret R.C. Chapters 4905 and 4909, and misconstrue the Commission's authority under the RAA.

IEU's arguments lack merit in any event.

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[6] The deference granted to the Commission's determination of its own jurisdiction, and the shortcomings on the merits of IEU's jurisdictional challenges, are further reflected in this Court's recent rejection of IEU's invocation of the Court's extraordinary writ powers to challenge the Commission's jurisdiction to proceed in the Capacity Case. *State ex rel. Indus. Energy Users-Ohio v. Pub. Util. Comm.*, 135 Ohio St.3d 367, 2013-Ohio-1472, 987 N.E.2d 645. If this Court agreed with the merits of IEU's dubious jurisdictional challenges, it could have issued the writs. Instead, this Court summarily granted the Commission's and AEP Ohio's motions to dismiss. *Id.*

1. **The Commission did not exceed its jurisdiction or "bypass" the requirements of R.C. 4928.141 through 4928.144 because those statutes apply to "retail electric service," not to the wholesale capacity service at issue.**

IEU argues that the Commission's ratemaking authority over the capacity service at issue is limited to R.C. 4928.141 through 4928.144. (*See* IEU Br. at 20-22). But that rests on two flawed assumptions: (1) that the capacity service at issue here is a *retail*—rather than *whole-sale*—service; and (2) that it is a *competitive* retail electric service. As the Commission correctly determined, the capacity service that AEP Ohio furnishes to CRES providers is not a retail electric service. *Capacity* Order at 13, 22, IEU Appx. at 57, 66. IEU's claim to the contrary belies reality. The Commission considered the definition of "retail electric service" in R.C. 4928.01(A)(27) and reached the obvious conclusion that *wholesale capacity service* does not fit. *Id.* This Court routinely gives considerable weight to the Commission's expertise where "highly specialized issues" are involved and where agency expertise would assist in discerning the intent of the General Assembly. *Consumers' Counsel v. Pub. Util. Comm.*, 58 Ohio St.2d 108, 110, 388 N.E.2d 1370 (1979). It should do so again here.

A retail electric service is "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." R.C. 4928.01(A)(27). The capacity service at issue here is one that AEP Ohio provides not to "ultimate consumers," but rather to CRES providers who then bundle that capacity with other wholesale components so as to sell complete retail electric generation service to their ultimate customers. "[A]lthough the capacity service benefits shopping customers in due course, [those retail customers] are initially one step removed from the transaction, which is more appropriately characterized as an intrastate wholesale matter between AEP Ohio and each CRES provider operating in the Company's service territory." *Capacity* Order at 13, IEU Appx. at 57.

The service at issue here, moreover, is not a "competitive" service. The Commission found it "unnecessary to determine whether capacity service is considered a competitive or non-competitive service under Chapter 4928, Revised Code." *Id.* Nevertheless, it is clear that wholesale capacity is not "competitive." As an FRR entity, AEP Ohio is obligated to provide capacity resources sufficient to support all shopping load in its service territory. (AEP Ohio Ex. 105 at 8, Supp. at 257; Tr. III at 662:2-3, Supp. at 580.) CRES providers who purchase capacity from AEP Ohio testified that they are "captive" to AEP Ohio and would otherwise have had to purchase and commit capacity to serve retail customers more than three years in advance of delivery, when they had few or no committed retail customers. (Exelon Ex. 101 at 8, Supp at 438; FES Ex. 103 at 8, 16-17, Supp. at 459, 467-68.) As Commissioner Roberto's concurring opinion in the *Capacity Case* recognized, "[n]o other entity may provide the service during the term of the current AEP Ohio Fixed Resource Requirement Capacity Plan [through May 2015]." *Capacity Case*, July 2, 2012 Concurring and Dissenting Opinion of Commissioner Cheryl L. Roberto, at 2, IEU Appx. at 87. It is thus clear that capacity service is not "competitive." Because the service is a wholesale service, and because it is not "competitive," R.C. Chapter 4928 is inapplicable and cannot limit the Commission's jurisdiction over the SCM. There is thus no merit to IEU's contention that the Commission "bypass[ed]" the requirements of R.C. 4928.141 through 4928.44. (*See* IEU Br. at 23.)

2. R.C. Chapters 4905 and 4909 support the Commission's exercise of jurisdiction, and the Commission's actions were consistent with R.C. 4905.26.

IEU also asserts that R.C. Chapters 4905 and 4909 apply only to retail rates. (IEU Br. at 22-30.) But the Commission correctly determined that R.C. 4905 and 4909 apply to wholesale services such as capacity service. *See* Second Rehearing Entry at 9, FES Appx. at 144. No provision of Chapters 4905 or 4909 of the Revised Code prohibits the Commission from initiating a review of or fixing a wholesale rate. Rather, Chapter 4905 grants the Commission broad "power and jurisdiction to supervise and regulate public utilities" within the State. *See, e.g.*, R.C. 4905.04, 4905.05, 4905.06. And Chapter 4909 endows the Commission with broad authority to fix, alter, or suspend rates. *See, e.g.*, R.C. 4909.03, 4909.16. If the General Assembly intended either Chapter 4905 or 4909 to be limited only to *retail* rates, then it would have said so. *See Taylor v. City of London*, 88 Ohio St.3d 137, 143, 2000-Ohio-278, 723 N.E.2d 1089; *AT&T Communications of Ohio, Inc. v. Ameritech Ohio*, PUCO Case No. 96-336-TP-CSS, Opinion and Order, at 17, 1997 Ohio PUC LEXIS 712, *43-44 (Sept. 18, 1997).[7] Although the Commission's authority to regulate wholesale electric service is subservient to federal law, the FERC-approved RAA authorizes the use of state compensation mechanisms, and FERC concluded that the SCM here is "consistent with the RAA." FERC Order at ¶ 26, Supp. at 841.

IEU's and OCC's arguments regarding the Commission's authority under R.C. 4905.26 also fail. IEU asserts that the Commission's authority to investigate rates that may be "unjust, unreasonable, unjustly discriminatory, unjustly preferential, or in violation of law" does not provide it with power to establish an SCM. (IEU Br. at 23.) OCC argues that the Commission must make an explicit finding regarding an existing rate's unjustness or unreasonableness before proceeding under R.C. 4905.26. (OCC Br. 13-19.) This Court's rulings that the Commission has

[7] This Court has repeatedly emphasized the Commission's authority to address wholesale charges under R.C. Chapter 4905. *See, e.g., AT&T Communications of Ohio, Inc. v. Pub. Util. Comm.*, 88 Ohio St.3d 549, 2000-Ohio-423, 728 N.E.2d 371 (complaint regarding wholesale interstate carrier access); *Time Warner AxS v. Pub. Util. Comm., et al.*, 75 Ohio St.3d 229, 235-236, 661 N.E.2d 1097 (1996) (Commission has authority to regulate basic local exchange service under R.C. Title 49, including wholesale network access to competing long-distance carriers); *MCI Telecommunications Corp. v. Pub. Util. Comm.*, 38 Ohio St.3d 266, 527 N.E.2d 777 (1988) (affirming Commission order setting transition plan for wholesale access charge).

broad authority to change rates pursuant to R.C. 4905.26 are flatly to the contrary. *See Ohio Consumers' Counsel*, 2006-Ohio-4706, at ¶ 29, citing *Lucas Cty. Commrs. v. Pub. Util. Comm.*, 80 Ohio St.3d 344, 347, 686 N.E.2d 501 (1997) ("Pursuant to R.C. 4905.26 * * *, the commission may conduct an investigation and hearing, and fix new rates to be substituted for existing rates, if it determines that the rates charged by the utility are unjust and unreasonable"); *Allnet Communications Servs., Inc.*, 32 Ohio St.3d at 117.

IEU asserts that, under *Lucas Cty. Commrs.* and *Ohio Util. Co. v. Pub. Util. Comm.* 58 Ohio St.2d 153, 389 N.E.2d 483 (1979), the Commission lacks authority to establish an SCM based on R.C. 4905.26 (IEU Br. at 23-24.) But *Lucas Cty. Commrs.* recognized that the Commission has broad ratemaking authority under R.C. 4905.26, holding only that the statute does not authorize the Commission to "order refunds or service credits to customers based on *expired rate programs*." (Emphasis added.) *Lucas Cty. Commrs.*, 80 Ohio St.3d at 347. Because the rates for capacity at issue here have not expired, that narrow holding is not applicable. Moreover, IEU's argument that *Ohio Util. Co.* limits the Commission's authority under R.C. 4905.26 cannot be reconciled with the opinion's statement that R.C. 4905.26 authorizes the Commission to set new rates "[i]f after an investigation and hearing pursuant to [R.C. 4905.26], the commission determines that existing rates are unjust or unreasonable." *Ohio Util. Co.*, 58 Ohio St.2d at 157. IEU essentially asks this Court to find that the Commission has broad authority to conduct proceedings under R.C. 4905.26, but is nearly without authority to fashion relief under the same statute. Such a narrow interpretation of R.C. 4905.26 would "strip[ ] it of its usefulness," *Ohio Util. Co.*, 58 Ohio St.2d at 157, and conflict with both the language of the statute and this Court's cases interpreting the Commission's authority under that provision.

OCC seeks to strip the complaint statute of its utility by imposing a requirement that the Commission issue an order declaring that it *finds* reasonable grounds for complaint *before* it can begin a proceeding under R.C. 4905.26. (OCC Br. at 13-19.) But the statute does not contain any such requirement, and neither this Court nor the Commission has ever recognized one. Such a holding would place form over substance and disregard the Commission's broad oversight over utility rates and the management of its docket. Moreover, when the Commission opened its investigation, it *found* that the existing capacity pricing mechanism risked an unjust and unreasonable result for AEP Ohio (R. 459 at 18, OCC Appx. at 107.) Such a finding satisfies the Commission's requirement to ensure that nothing under its purview is, as the language in R.C. 4905.26 states, "in any respect" unjust or unreasonable.

Like the case law IEU cites, the case law OCC invokes is inapposite. *Ohio Util. Co.* requires that there be "reasonable grounds" to consider a matter under R.C. 4905.26, *not* that those grounds must be put into an entry in a specific manner at a specific time. *See Ohio Util. Co.*, 58 Ohio St.2d at 157. *Western Reserve* also does not require the Commission to make any explicit prerequisite finding of reasonable grounds for complaint. *See Western Reserve Transit Authority v. Pub. Util. Comm.*, 39 Ohio St.2d 16, 313 N.E.2d 811 (1974). In that case, the Court reversed the Commission's dismissal of a case before holding a hearing, but after the Commission issued an entry finding that reasonable grounds for complaint "may exist." *Id.* at 19. The Court then ordered the Commission not to make an explicit finding of reasonable grounds for complaint, but *to hold a hearing*—which the Commission has done here. *Id.* Neither case that OCC cites supports its overly restrictive interpretation of R.C. 4905.26.

3. EU misconstrues the Commission's authority under the RAA and, in any event, failed to preserve the issue for appeal.

IEU contends that "the RAA does not provide the Commission any authority to invent a cost-based ratemaking methodology" for "capacity-related compensation." (IEU Br. at 28.) IEU failed to raise this argument in any application for rehearing; thus, the argument is not properly before the Court. (*See Cameron Creek Apts. v. Columbia Gas of Ohio, Inc.*, Slip Op. No. 2013-Ohio-3705, ¶¶23-24 (failure to specify claim on rehearing "deprives this court of jurisdiction" over the claim).) Besides, the RAA contemplates that pricing for an FRR entity's capacity may be determined through an SCM—it expressly endorses state compensation mechanisms—which *supports* the Commission's establishment of such a mechanism. *Capacity* Order at 7, IEU Appx. at 51. And, as discussed above, Ohio law provides the Commission authority to establish capacity charges, eliminating any need to look to the RAA for that authority.

At bottom, Appellants cannot avoid this Court's long line of authority recognizing the Commission's broad regulatory authority over public utilities. There can be no doubt that the General Assembly has spoken broadly about that jurisdiction. *E.g.*, *Corrigan v. Illuminating Co.*, 122 Ohio St.3d 265, 2009-Ohio-2524, 910 N.E.2d 1009, ¶ 8 ("This 'jurisdiction specifically conferred by statute upon the Public Utilities Commission over public utilities of the state * * * is so complete, comprehensive and adequate as to warrant the conclusion that it is likewise exclusive.'"), quoting *State ex rel. Northern Ohio Tel. Co. v. Winter*, 23 Ohio St.2d 6, 260 N.E.2d 827 (1970). This Court has described the Commission's wide-ranging authority over public utilities as "broad and complete." *Kazmaier Supermarket, Inc. v. Toledo Edison Co.*, 61 Ohio St.3d 147, 150-151, 573 N.E.2d 655 (1991). As the Court explained:

> R.C. Title 49 sets forth a detailed statutory framework for the regulation of utility service and the fixation of rates charged by public utilities to their customers. As

> part of that scheme, the legislature created the Public Utilities Commission and empowered it with broad authority to administer and enforce the provisions of Title 49.

Id. at 150. Indeed, "there is perhaps no field of business subject to greater statutory and governmental control than that of the public utility." *Id.* In light of this, it would be exceptional for this Court to conclude that the Commission lacks jurisdiction over the capacity rates at issue.

<u>Proposition Of Law No. IV</u>: The Commission correctly determined that a full base rate case proceeding was not required here. [IEU Prop. IV; FES Prop. III]

In its Prop. IV, IEU contends that the Commission's *Capacity* orders are unreasonable and unlawful because the Commission did not conduct a full-blown base rate case pursuant to R.C. Chapter 4909. (IEU Br. at 32-35.) FES makes a similar claim in parts (1) and (2) of its Prop. III. (FES Br. at 26-32.) Those arguments lack merit. Again, the Commission established RPM as the wholesale price that CRES providers would pay for capacity; the Commission did not set retail rates for the recovery of deferred costs.

The Court will review IEU Prop. IV and FES Prop. III (1) and (2) in vain for citation to precedent from this or any other court supporting the theory that a full-blown traditional base rate case proceeding was required here, where the Commission did not actually set base rates. As this Court has recognized, the Commission is vested with broad discretion to manage its dockets and to decide how it may best proceed to manage the orderly flow of its business. *Toledo Coalition for Safe Energy v. Pub. Util. Comm.*, 69 Ohio St.2d 559, 560, 433 N.E.2d 212 (1982). And as the Commission correctly recognized, strict adherence to the procedural and substantive requirements applicable to a base rate proceeding was not required here because the Commission's investigation was not a traditional base rate case. Rehearing Entry at 54., IEU Appx. at 143. Here, the *Commission* (not a base rate applicant) initiated the proceeding in response to AEP

Ohio's FERC filing to review the capacity charge associated with AEP Ohio's FRR obligations. Moreover, as discussed above, R.C. 4905.26 authorized the Commission to do so. That statute requires only that the Commission hold a hearing and provide notice. *See* R.C. 4905.26. The Commission conducted its proceeding in full compliance with those requirements. It permitted extensive discovery, written and oral testimony, cross-examination, voluminous hearing exhibits, and additional argument through briefing. The massive record before this Court confirms that the adjudicatory process was more than sufficient.

Moreover, the proceeding below could properly be construed as a "first filing" of rates for a service not previously addressed in a Commission-approved tariff. R.C. 4909.18. Such a "first filing" does not require *any* hearing, much less the extensive hearings that the Commission conducted, in which IEU fully and actively participated. *Id.*; *see also Consumers' Counsel*, 2006-Ohio-5789, at ¶18 (the notice, investigation, and hearing requirements of R.C. Chapter 4909 apply only to applications for a rate *increase* pursuant to R.C. 4909.18 and the Commission has discretion to determine whether a rate increase is sought and a hearing necessary). Nor does such a "first filing" require the application of a rate base, rate-of-return, cost methodology. *Ohio Domestic Violence Network v. Pub. Util. Comm.*, 70 Ohio St.3d 311, 323, 638 N.E.2d 1012 (1994).

<u>Proposition of Law No. V</u>: Appellants' challenges to the Commission's grant of an accounting deferral for certain of AEP Ohio's capacity-related costs are without merit. [OCC Prop. II and Prop. III; IEU Prop. V]

The Court has long recognized the Commission's substantial authority and discretion to implement regulatory accounting deferrals:

> R.C. 4905.13 grants the commission authority to establish a system of accounts for public utilities and to prescribe the manner in which the accounts must be kept. We have recognized the commission's discretion under R.C. 4905.13 and have held that we "generally will not interfere with the accounting practices set by

> the commission." *Consumers' Counsel v. Pub. Util. Comm.* (1987), 32 Ohio St.3d 263, 271, 513 N.E.2d 243. Moreover, we have stated that where, as here, "a statute does not prescribe a particular formula, the PUCO is vested with broad discretion." *Payphone Assn. of Ohio v. Pub. Util. Comm.,* 109 Ohio St.3d 453, 2006-Ohio-2988, 849 N.E.2d 4, at ¶ 25, citing *Columbus v. Pub. Util. Comm.* (1984), 10 Ohio St.3d 23, 24, 10 OBR 175, 460 N.E.2d 1117.

Elyria Foundry Co. v. Pub. Util. Comm., 114 Ohio St.3d 305, 2007-Ohio-4164, 871 N.E.2d 1176, ¶ 18. For that reason alone, Appellants' arguments fail.

Further, the Court has recognized that the Commission's authority over utility accounting pursuant to R.C. 4905.13 is distinct from its ratemaking authority. *Id.*; *Consumers' Counsel v. Pub. Util. Comm.*, 6 Ohio St.3d 377, 378-79, 453 N.E.2d 673 (1983). This Court consistently refuses to interfere with accounting practices established by the Commission when the accounting procedure does not affect current rates and the ratemaking effect of the accounting order will be reviewed later. *See Elyria Foundry*, 2007-Ohio-4164, at ¶ 18; *Consumers' Counsel v. Pub. Util. Comm.*, 63 Ohio St.3d 522, 524, 589 N.E.2d 1267 (1992); *Consumers' Counsel v. Pub. Util. Comm.*, 32 Ohio St.3d 263, 271, 513 N.E.2d 243 (1987); *Consumers' Counsel v. Pub. Util. Comm.*, 6 Ohio St.3d 377 (1983). None of Appellants' challenges to the accounting deferral demonstrates harm arising from a violation of Ohio law. As demonstrated below, each challenge is premature and meritless.

A. Appellants' challenges to the ratemaking decision involving the deferred capacity costs are premature and should be heard in Case No. 2013-521. [OCC Prop. II and Prop. III; IEU Prop. V]

OCC maintains that the accounting order results in harm to retail customers, relying on this Court's decision in *Elyria Foundry*. (OCC Br. at 24-26.) But there was no harm to ratepayers from the accounting deferral authorization here. And the Commission's decision did no more than approve the accounting deferrals; it did not conclusively determine the ratemaking issues being challenged by OCC and IEU. The Commission's *Capacity* Order was clear on this point:

> Further, the Commission will authorize AEP Ohio to modify its accounting procedures, pursuant to Section 4905.13, Revised Code, to defer incurred capacity costs not recovered from CRES provider billings during the ESP period to the extent that the total incurred capacity costs do not exceed the capacity pricing that we approve below. Moreover, the Commission notes that we will establish an appropriate recovery mechanism for such deferred costs and address any additional financial considerations in the [*ESP II*] proceeding.

Capacity Order at 24, IEU Appx. at 68.

The ratemaking issues challenged by OCC and IEU were not resolved in the decision below. They were resolved instead in the *ESP II* decision that is subject to a separate appeal in Case No. 2013-521. The Commission made that clear yet again when it responded to OCC's application for rehearing on the accounting deferral (OCC AFR at 16-25 (Aug.1, 2012), OCC Appx. at 69-75.) Rejecting OCC's efforts to inject those ratemaking matters into this case, the Commission explained that its decision had not resolved them and they were, as a result, "prematurely raised." Rehearing Entry at 51, IEU Appx. at 140. It explained that "[t]he Capacity Order did not address the deferral recovery mechanism" and reiterated that it would establish "an appropriate recovery mechanism" and address "any other financial considerations" in the *ESP II* case. *Id.* Because OCC advances premature ratemaking challenges, they should be deferred to Case No. 2013-521 where this Court will review the separate ratemaking order.

OCC nonetheless argues that its challenge is not premature, invoking *Elyria Foundry*. (OCC Br. at 25-26.) But this Court in *Elyria Foundry* found that the accounting deferral "was not merely an accounting order" because it made certain determinations that were "conclusive for ratemaking purposes" and "violated R.C. 4928.02(G)." *Elyria Foundry*, 2007-Ohio-4164, at ¶

57. As shown above, however, the Commission here clearly stated that it was *not* deciding the ratemaking issues as part of its decision authorizing the accounting deferrals. *Capacity* Order at 23, IEU Appx. at 67; Rehearing Entry at 38, IEU Appx. at 127. And the Commission explicitly found that OCC's ratemaking complaints were a premature attempt to anticipate the *ESP II* decision. Rehearing Entry at 51, IEU Appx. 140.

Were the Court to conclude that the accounting deferral authorization somehow constitutes a ratemaking determination that causes harm to Appellants, it should defer consideration of the underlying legal issues to Case No. 2013-521. Because the decision below did not affect a substantial right of appellants (because the ratemaking issues were resolved in the separate *ESP II* proceeding), the Court can avoid piecemeal appeals by resolving the ratemaking disputes in Case No. 2013-521. *See Cincinnati v. Pub. Util. Comm.*, 63 Ohio St.3d 366, 368-69, 598 N.E.2d 775 (1992) (dismissing ratemaking claims raised on appeal from an accounting order because of a separate rate case pending that afforded appellants an opportunity to challenge the final rate determination); *Senior Citizens Coalition*, 40 Ohio St.3d 329.

B. The accounting deferral does not create an unlawful subsidy or require customers to "pay twice" for capacity service, and Appellants' other improper attempts to second-guess the Commission's rate design expertise should be rejected. [OCC Prop. II, Prop. III.A and Prop. III.C; IEU Prop. V.2 and Prop. V.5]

Appellants' claims about pricing are both premature and without merit.

1. There is no unlawful double payment or overpayment for capacity. [OCC Prop. II; IEU Prop. V.5]

OCC claims that both shopping and non-shopping customers will be forced to pay twice for capacity service as a result of the accounting deferral. (OCC Br. at 19-20.) IEU similarly argues that non-shopping customers overpay to the extent that the bundled SSO generation rate incorporates a capacity charge higher than the cost-based rate adopted below for shopping customers. (IEU Br. at 41-42.) In addition to being premature ratemaking challenges that are beyond the scope of this appeal, those arguments are both incorrect.

First, the embedded capacity component of SSO generation service is distinct from the unbundled capacity service provided to CRES providers to support shopping. The fact that two different charges might apply to two different services—both of which broadly relate to capacity—cannot be used to suggest that customers wrongly "pay twice" or overpay for capacity. The distinctions between wholesale capacity (supporting shopping customers) and retail SSO service (to non-shopping customers), along with the full rationale supporting the retail charges, were further explained in the *ESP II* decision. But that decision should only be reviewed by this Court in Case No. 2013-521.

Second, the Commission's ability to implement nonbypassable charges in connection with approving an electric distribution utility's SSO generation rate plan (to be addressed in Case No. 2013-521) will eliminate any basis for challenging the accounting deferral associated with those charges. If the Commission can authorize recovery of the charges from all customers, then the accounting deferral pending the development of that recovery method is lawful as well. *Consumers' Counsel*, 2006-Ohio-5789, at ¶38 (so long as the Commission has ratemaking authority to reflect the underlying costs in utility rates, it also has authority to implement the preliminary and "smaller step" of allowing an accounting deferral). For that reason too, the ratemaking matters should be addressed by this Court only in reviewing the ratemaking decision, not the accounting deferral decision below.

Third, OCC ignores and defies the record in contending that non-shopping customers pay something for nothing when they contribute toward recovery of the accounting deferral. *All customers benefit* from the opportunity to shop for generation service, not just those who actually shop. The Commission correctly found that the accounting deferral was necessary in order to promote competition:

> In short, the record reveals that RPM-based capacity pricing would be insufficient to yield reasonable compensation for AEP Ohio's provision of capacity * * * However, the Commission also recognizes that RPM-based capacity pricing will further the development of competition in the market * * * which is one of our primary objectives in this proceeding. * * * For that reason, the Commission directs AEP Ohio to charge CRES providers the adjusted final zonal PJM RPM rate * * * [.] Further, the Commission will authorize AEP Ohio to modify its accounting procedures, pursuant to Section 4905.13, Revised Code, to defer incurred capacity costs not recovered from CRES provider billings during the ESP period to the extent that the total incurred capacity costs do not exceed the capacity pricing that we approve below.

Capacity Order at 23, IEU Appx. at 57. Thus, the accounting deferral was adopted to benefit non-shopping customers who stand to benefit from a more competitive market as well. Besides, *all* customers will pay the non-bypassable charge (SSO customers and CRES customers) needed to support the capacity service they benefit from. The Commission determined that under the SCM, no one gets something for nothing and no one pays for something they do not receive; Appellants' challenge to that determination is not a matter of law but simply an attempt to improperly second guess the Commission by invading its discretion and expertise. In any case, the ultimate question of whether and which ratepayers should be charged for the capacity deferral (and on what basis) was addressed by the Commission in the *ESP II* decision—which this Court will review in Case No. 2013-521.

2. There is no unlawful anti-competitive subsidy under R.C. 4928.02(H). [OCC Prop. III.A; IEU Prop. V.2]

OCC Prop. III.A argues that the accounting deferral creates an unlawful subsidy of a wholesale competitive service through retail customers. (OCC Br. at 20-24.) Similarly, IEU

Prop. V.2 maintains that the accounting deferral creates an anti-competitive subsidy in violation of R.C. 4928.02(H). (IEU Br. at 38-39.) These arguments mischaracterize the decision below.

As an initial matter, R.C. 4928.02(H) applies only to subsidies to a competitive retail electric service. OCC's argument thus could not have merit unless the capacity service being priced here were both retail and competitive. *See* OCC Br. at 22. As AEP Ohio explained, however, the service priced below was neither retail nor competitive. There is simply no reasonable way to characterize AEP Ohio's exclusive obligation to provide capacity resources to support both shopping and non-shopping load as competitive.

OCC also argues that, because the capacity costs originated as part of a wholesale transaction and are ultimately recovered through retail rates, the decision violates R.C. 4928.02(L)'s policy for protecting at-risk populations. (OCC Br. at 23-24.) OCC's application of the phrase "at-risk populations" is nonsensical; the statutory language could not possibly have been intended to refer to all customers. Nonetheless, the decision *will* benefit all customers by promoting competition and ensuring that AEP Ohio will have sufficient compensation to provide capacity service. The *raison d'etre* for the Commission decision to charge CRES providers a lower capacity rate (and, by extension, the accounting deferral to make AEP Ohio whole) was to *promote* competition, not destroy it. *See, e.g., Capacity* Order at 23-24, 33, 35, IEU Appx. at 67-68, 77, 79; Rehearing Entry at 6, 40, 42, IEU Appx. at 95, 129, 131. This Court, moreover, recently sanctioned an accounting deferral to recover wholesale transmission costs imposed under federal law upon retail customers, even though the costs were incurred during a period when generation rates were to remain frozen. *Consumers' Counsel*, 2006-Ohio-5789, at ¶ 46. And this Court has explained—in the very context of the Commission interpreting other R.C. Title 49 provisions when implementing accounting authority—"due deference should be given to statutory interpretations by an agency that has accumulated substantial expertise and to which the General Assembly has delegated enforcement responsibility." *Id.* at ¶ 41. That time-tested principle should be followed here.

Finally, the Court has long recognized that the Commission has flexibility to promote competition using reasonable distinctions and rate designs. Even before S.B. 221's second wave of electric restructuring, it was lawful under S.B. 3 to implement shopping credits that reduced the utility's charges to some customers in order to promote shopping. As this Court described the shopping credits approved by the Commission under S.B. 3:

> Shopping credits are a deduction against [the utility's] own generation charges on the bills of customers who switch to a competitive supplier for their generation services. Customers may also avoid paying a portion of the rate-stabilization charge if they commit to obtaining electric generation from another supplier. The credits are designed to encourage customer shopping for energy generation supplied by a competitive retail electric service.

Consumers' Counsel v. Pub. Util. Comm., 109 Ohio St. 3d 328, 2006-Ohio-2110, 847 N.E.2d 1184, ¶ 21 (internal citations omitted). By shopping and taking advantage of offered credits, customers partially avoided paying a non-bypassable "wires" charge that was paid by all non-shopping customers. The Court rejected OCC's theory that the credits discriminated against non-shopping customers. *Id.* at ¶ 25. It should again reject OCC's similar theory regarding the deferral here.

3. The Commission is not required to follow Appellant's rate design suggestions. [OCC Prop. III.C]

OCC's "cost causation" challenge to the accounting deferrals also lacks merit. (OCC Br. at 26-28.) The ratemaking principle of "cost causation," whereby there is a goal of ultimately establishing rates that collect costs from the customers that cause the cost to be incurred, is nonbinding. This Court has frequently acknowledged that decisions about how rates are designed—including which customers pay and under what circumstances—are matters within the Commission's discretion. *Green Cove Resort Owners' Ass'n. v. Pub. Util. Comm.*, 103 Ohio St.3d 125, 2004-Ohio-4774, 814 N.E.2d 829, ¶ 1 (recognizing the Commission's "unique rate-design expertise"); *Citywide Coalition for Util. Reform v. Pub. Util. Comm.*, 67 Ohio St.3d 531, 533, 620 N.E.2d 832 (1993) (affording the Commission "considerable discretion" in matters of rate design); *see also Consumers' Counsel*, 32 Ohio St.3d at 268 (ratemaking involves extensive hearings, voluminous testimony, and technical questions which must be resolved on the basis of complex and often disputed evidence; the Court's function is not to weigh the evidence or choose between debatable rate structures). Appellant's disagreement with the Commission's discretion provides no appropriate basis for reversal.

C. IEU's miscellaneous challenges to the deferral also lack merit. [IEU Prop. V.1, Prop. V.3 and Prop. V.4]

IEU sprinkles into its brief three more passing challenges to the accounting deferral. First, IEU Prop. V.1 attacks the deferral using the misguided notion that any cost-based rate above what it characterizes as "market" levels is unlawful as an untimely transition cost. (IEU Br. at 35-38.) According to IEU, R.C. 4928.38 proscribed above-market recoveries and transition charges in 2005. (IEU Br. at 35-38.) But, as AEP Ohio has explained, generation transition charges are not at issue here. *See* Prop. II.A., supra at 14-16.

Second, IEU Prop. V.3 wrongly claims that the Commission's approval of the accounting deferral violates R.C. 4928.05(A). (IEU Br. at 39-40.) That statute, IEU contends, indirectly precludes the Commission's from authorizing an accounting deferral regarding competitive retail generation except under R.C. 4928.144, which can only be exercised in an SSO proceeding. (*Id.*)

That argument is circular and incorrect. The Commission did, in fact, rely on R.C. 4928.144 in authorizing recovery of the deferral, and it did so as part of the *ESP II* decision. More importantly, the Commission properly found that the service being priced is a wholesale service, thus rejecting IEU's argument that the restrictions of R.C. 4928.05(A) apply. *Capacity* Order at 13, IEU Appx. at 57; Rehearing Entry at 39, IEU Appx. at 128.

Third, IEU Prop. V.4 contends that the Commission erred in directing AEP Ohio to reflect a carrying charge in its accounting deferral. (IEU Br. at 40-41.) That "one-pager" challenge is without merit. Of course, a carrying charge is an appropriate extension of the Commission's broad authority over utility accounting. R.C. 4905.13. A carrying charge reflects the real cost of money that AEP Ohio realizes by incurring millions of dollars in costs to provide capacity service *now* only to recover the costs years *later*, after the accounting deferral is amortized. All of the costs included in the accounting order, including the carrying charges,[8] are subject to audit and the rigors of ratemaking—*just not as part of the accounting order*. The Commission explained that including a carrying charge up front is routine and attendant to an accounting order:

> As we have noted in other proceedings, once collection of the deferred costs begins, the risk of non-collection is significantly reduced. At that point, it is more appropriate to use the long-term cost of debt rate, which is consistent with sound regulatory practice and Commission precedent.

Rehearing Entry at 43, IEU Appx. at 132. IEU's challenge that there is no specific evidence supporting the Commission's boilerplate carrying-charge provision ignores the reality that deferred recovery of costs incurred necessarily involves the time value of money.

[8] AEP Ohio notes that the higher carrying charge objected to by IEU, known as the weighted average cost of capital, was never triggered and the lower cost of debt carrying charge is all that is being booked. Rehearing Entry at 42.

D. **If the Court somehow determines that the deferral violates Ohio law, it should remand the case to the Commission with instructions to address recovery of the undiscounted capacity cost through rates.**

If the Court were to determine that the accounting deferral was unlawful—and it should not—the appropriate remedy is not to reverse or vacate. It is to remand with instructions to address cost recovery. Because the Commission found that AEP Ohio incurs costs equal to $188.88/MW-day to provide capacity to serve shopping customer load, the only appropriate remedy in the event the Commission has unlawfully deferred recovery is a remand with directions to address how AEP Ohio is to fully recover the $188.88/MW-day costs. The Commission found that the pre-existing capacity price would cause AEP Ohio to earn an "unusually low return on equity" and be "insufficient to yield reasonable compensation" *Capacity* Order at 23, IEU Appx. at 67. Likewise, it was imperative that the AEP Genco be given assurances that its generation assets would not be conscripted into such involuntary servitude, if it were to proceed with corporate separation. In sum, absent such an affirmative directive from the Court, the consequence of a reversal or *vacatur* could be that AEP Ohio would collect only an RPM rate that is far below its cost of providing service—in violation of the U.S. Supreme Court decision in *Hope* and *Bluefield*. *See* pp. 17-18, *supra*.

<u>Proposition of Law No. VI</u>: The Commission processed the underlying case appropriately; IEU's claims seeking to retroactively adjust rates are inappropriate and should be denied. [IEU Prop. VI, Prop. VII, and Prop. VIII]

IEU raises a number of arguments that relate in some manner to the authority of the Commission to set interim capacity rates and IEU's preference for some type of refunding mechanism. (IEU Br. at 42-45.) The issues raised either relate to actions in the *ESP II* proceeding or deal with rates that expired during the processing of this case. In short, these claims are not properly before this Court and otherwise lack merit.

IEU argues that the Commission failed to restore the RPM price as required by R.C. 4928.143(C)(2)(b) when rejecting the *ESP II* stipulation. (*Id.* at 42-43.) IEU next asserts that the temporary rate implemented before the final *Capacity* Order was not record-based. (*Id.* at 43-45.) IEU also argues that the Commission lacks authority to set capacity pricing and, therefore, the Commission should be forced to refund any price IEU characterizes as above-market. (*Id.* at 45-46.) As AEP Ohio and the Commission previously explained, IEU's arguments all relate to *interim* rates that the Commission set for capacity service during the underlying proceeding. *See* Case No. 2012-2098, *et al.*, Mem. Supp. Jt. Mot. to Dismiss at 2-7, Supp. at 788.[9] Those rates are no longer effective, are no longer being collected, and have been replaced by other rates. The interim rates were never stayed pending appeal or otherwise (nor was the required bond or other undertaking executed). *Id.* at 5-6. And the prohibition against retroactive ratemaking precludes the refunds that IEU seeks. *Id.*

Further, IEU seeks to improperly appeal a matter related to the SSO governed by the *ESP II* proceeding that is pending on review before this Court in Case No. 2013-521. (IEU Br. at 42-43.) What the Commission decided to do or not do with the SSO is a matter for that proceeding. Here, the Commission informed the parties in December 2010 that it was going to study the SCM and began an investigation. The prior stipulation that merged the SSO case with the capacity pricing issues was rejected, and the Commission subsequently separated the dockets again and moved forward. The processing of the SSO in the *ESP II* proceeding did not limit the Commission's authority in the investigation of capacity pricing.

[9] AEP Ohio incorporates the arguments set forth in the August 14, 2013 Joint Motion to Dismiss as if set forth fully herein.

IEU also attempts to call into question the Commission's authority to manage its dockets. IEU's attempt to parse the Commission's actions given this case's procedural complexities is inappropriate. (*Id.* at 43-45.) So too is its request for a refund. (*Id.* at 45-56.) Even if the rates at issue were still being collected (which they are not), retroactive refunds are barred by the prohibition against retroactive ratemaking: "The rule against retroactive rates * * * also prohibits its refunds." *In re Columbus S. Power Co.,* 128 Ohio St.3d 512, 2011-Ohio-1788, 947 N.E.2d 655, ¶ 15). For these reasons and those advanced in the August 14, 2013 Joint Motion to Dismiss, this Court should reject IEU Props VI, VII and VIII.

<u>Proposition Of Law No. VII</u>: The Commission afforded all parties due process. [IEU Prop. IX]

IEU's final proposition sounds in due process. (IEU Br. at 46-48.) Ample process was provided here. IEU just does not agree with the outcome. The Commission has broad authority to ensure fair pricing for customers, provide flexibility to encourage the development of competitive markets, protect customers from unreasonable sales practices, market deficiencies, and market power, as well as to pursue other policies expressed in R.C. 4928.02.

The Commission's extensive docket in this case, which has almost 600 entries, demonstrates that the parties were afforded an extraordinary right to be heard. The Commission initiated the case as an investigation in December of 2010. It took comments from the industry, including IEU. The docket was consolidated with the SSO docket when a stipulation was filed. Supporting and opposing testimony was filed on the Stipulation and an extensive hearing was held. The Commission approved the Stipulation and later withdrew that approval on rehearing, *as requested by IEU.* The Commission then held a hearing focused on the underlying capacity case and provided another opportunity for testimony in support of all positions. Again, an order was issued with full rights for rehearing. The ability for the Commission to reconsider matters on rehearing and initiate investigations are integral steps in that process. IEU was afforded all the process required by law, and the voluminous record in this case demonstrates that IEU did not lack the opportunity to share its views.

AEP OHIO'S CROSS-APPEAL

<u>Proposition of Law No. VIII</u>: The PUCO may not reduce AEP Ohio's cost-based capacity rate using an energy credit that incorporates demonstrably inaccurate inputs.

As explained above, the Commission calculated the cost-based rate for capacity in two steps. First, it determined the book costs of AEP Ohio's generation assets. Second, it developed a credit to offset against those costs based onrevenues AEP Ohio would realize by selling energy "freed up" by its sale of capacity to CRES providers. The theory behind the credit is that, when capacity provided by generation assets is sold to a CRES provider, the assets' potential to generate energy for sale to third parties is "freed up." The energy credit thus offsets the Company's capacity costs with the margins AEP Ohio realizes from energy-related sales produced by that capacity. *Capacity* Order at 33-35, IEU Appx. at 77-79. AEP Ohio is not appealing the Commission's first step. Rather, AEP Ohio is challenging the amount of the energy credit that the Commission determined in the second step. The Commission methodology is riddled with fundamental errors. The resulting energy credit is grossly *over*stated, rendering the capacity rate severely *under*stated.

A. The energy credit is unreasonably and unlawfully overstated because it is based on a static shopping assumption that is lower than actual shopping levels.

The Commission's energy credit methodology relies in large part upon the level of shopping for electricity during the time frame to which the energy credit relates. An increase in shopping decreases the energy credit (and thus increases the Company's cost-based capacity rate), while a decrease in shopping has the opposite effect. (Tr. X at 2190-91, Supp. at 595; Staff Ex. 105 at 19, Supp. at 560.) Despite this dependent relationship, the Commission's energy credit unreasonably incorporates a *static* shopping level of 26.1%, which reflects the level of shopping on March 31, 2013. (Staff Ex. 105 at 19, Supp. at 560; AEP Ohio Ex. 142 at 21, Supp. at 323.)

In using that static assumption, the Commission disregarded uncontroverted evidence both that (1) the level of shopping had already increased substantially by the time of the hearing and before the *Capacity* Order; and (2) shopping is expected only to *increase* going forward, including the period when AEP Ohio is charging the capacity rate that the Commission approved. Indeed, in only one month, the level of shopping in AEP Ohio's service territory rose more than 4%—from 26.1% as of March 31, 2012, to 30.19% as of April 30, 2012. (AEP Ohio Ex. 142 at 21, Supp. at 323.) And the Commission explicitly recognized and affirmatively intended that its *Capacity* Order will "stimulate competition among suppliers in AEP Ohio's service territory." Order at 23. The Commission's arbitrary adoption of a static 26.1% shopping assumption in its energy credit calculation for the entire period through May 2015 cannot be reconciled with the 30.19 % level that had already been reached before the hearing concluded and the Commission's recognition that shopping will increase under the RPM pricing it established.

The impact of *increased* (versus static) shopping is substantial. At a shopping level of only 50%, for example, the Company's net capacity costs increases from the Commission's adopted price of \$188.88/MW-day to \$215.88/MW-day. (AEP Ohio Ex. 143 at 7, Supp. at 354.) At a 75% shopping level, the net capacity cost increases to \$245.13/MW-day. (*Id.*) Even the 4% increase in shopping that occurred between March 31 and April 30, 2012 would correspond to a decreased energy credit of \$4.50/MW-day and an increase in the net capacity cost in the same amount—resulting in a net capacity cost of \$193.30/MW-day. The Commission's failure to account for the increases in shopping that already have occurred and will occur is unreasonable, unlawful, and financially harmful to AEP Ohio. As such, the Court should remand this case to correct this failure by adjusting the energy credit based on an appropriate, non-static shopping assumption.

B. The energy credit is unreasonably and unlawfully overstated because it is based on fundamental technical errors and utilizes an opaque modeling methodology incapable of meaningful scrutiny.

Although this Court has traditionally deferred to the Commission in areas involving its special expertise, such deference is not appropriate where the decision is unreasonable and unsupported by the record. *See, e.g., Tongren v. Pub. Util. Comm.*, 156 Ohio St.3d 87, 89, 1999-Ohio-206, 706 N.E.2d 1255. This Court has thus previously deferred to the Commission's selection of one of multiple *defensible* methodologies or formulas. *Ohio Edison Co. v. Pub. Util. Comm.*, 173 Ohio St. 478, 483-84, 184 N.E.2d 70 (1962). But such deference is not required where the Court doubts the reliability or reasonableness of a methodology or model. *See, e.g., In re Application of Columbus Southern Power Co.*, 2011-Ohio-1788, at ¶ 25-26. That is precisely the case here (even apart from the flawed shopping assumption discussed above). As explained below, the adopted energy credit model utilizes a number of flawed inputs, each resulting in the energy credit being overstated and the resulting capacity rate being unreasonably understated. (*See* AEP Ohio AFR at 13-43, Appx. At 19, 49.)

As a threshold matter, the Commission's energy credit methodology is unreasonable and unlawful because it is based on a "black box" model that cannot be meaningfully evaluated or tested. All of the data used in the model was either off-the-shelf from the developer's default database or developed by others, so the witness sponsoring the model could not answer questions about it. (Tr. IX at 1865, Supp. at 585.) Many of the model's inputs remain unknown. (*Id.* at

1844, 1872-74, Supp. at 584, 586-88 Tr. X at 2151, 2158-59, Supp. at 590.) That missing information makes it impossible to assess critical inputs to the model or verify that it was used appropriately. (AEP Ohio. Ex. 144 at 13-16, Supp. at 383-86.) This Court has recently made clear that the adoption of models or formulas must be accurately and verifiably supported by the record. *See Columbus Southern Power*, 2011-Ohio-1788, at ¶ 25-26. Moreover, at least one utility commission in another jurisdiction has rejected the very model that the Commission adopted in this case for this very reason. *See, e.g., In the Matter of Idaho Power Company*, 2005 Ore. PUC LEXIS 349, *17 (July 28, 2005) (concluding that "the model fails to accurately forecast market electricity prices under normalized conditions"). This Court should do so too.

Equally troubling is the fact that the model was not properly calibrated. (*See* AEP Ohio Ex. 144 at 10-11, Supp. at 380-81; Tr. X at 2210-11, 2163-64, Supp. at 597-98, 593-94.) The failure to properly calibrate the model was critical, causing the model to be unsuitable and inaccurate. (AEP Ohio Ex. 144 at 11, Supp. at 380-81.) AEP Ohio showed that, had this "most basic step" in any modeling analysis been undertaken, it would have revealed that the model's final run overstated gross energy margins by more than 20%. (*Id.* at 12-14, Supp. at 382-84.) Courts have long recognized the critical necessity of properly calibrating any model used to support an adjudicative determination. For example, the United States District Court for the Eastern District of California noted that "it is undisputable that calibration is a 'critical' and 'valuable' step that ensures that model simulation matches the field observation to a reasonable degree." *Abarca v. Franklin County Water Dist.*, 761 F.Supp.2d 1007, 1060 (E.D. Cal. 2011).[10] The model at issue here was not properly calibrated before it was used to calculate the Commission's energy credit.

[10] The *Abarca* court further noted that appellate courts "*throughout the United States have emphasized calibrating/harmonizing model predictions with actual data to ensure reliability.*"

The Commission disregarded clear evidence that its adopted energy credit wrongly incorporates traditional off-system sales ("OSS") margins and does not properly reflect the impact of the AEP System Interconnection Agreement ("Pool") on OSS margins. AEP Ohio demonstrated at hearing, in its post-hearing briefs, and in its application for rehearing that the energy credit wrongly incorporates OSS margins associated with capacity not even used to support shopping; improperly imputes a market-based margin for non-shopping customers; and does not adjust OSS margins to take into account AEP Ohio's 40% Member Load Ratio ("MLR") under the Pool Agreement. (*See, e.g.,* AEP Ohio AFR at 38-42, Appx. at 44-48.) These errors confiscate revenues from AEP Ohio's retail SSO sales and use them to subsidize CRES providers through a lower wholesale rate for capacity. (AEP Ohio Ex. 143 at 6, 11, Supp. at 353, 358.) Moreover, individually and in the aggregate, they inflate AEP Ohio's retained energy margins and, ultimately, the adopted energy credit, resulting in a capacity rate that is substantially understated. Finally, they violate the Company's FERC-approved Pool Agreement and the Federal Power Act and conflict with Ohio's energy policy and basic economic principles.

(Emphasis added.) *Id.* at n.55, citing *Eleven Line, Inc. v. North Texas State Soccer Assn., Inc.*, 213 F.3d 198, 206-08 (5th Cir. 2000) (antitrust context); *Inland Empire Public Lands Council v. Schultz*, 992 F.2d 977, 982 (9th Cir. 1993) (agency conducted "extensive field investigations to calibrate and verify its models"); *Sterling v. Velsicol Chem. Corp.*, 855 F.2d 1188, 1199 (6th Cir. 1988) ("The plaintiffs carefully devised, calibrated, and tested their model, based upon physical data generated by Velsicol's own consultants, to determine the physical and chemical characteristics beneath the landfill."); *Ohio v. United States Environmental Protection Agency*, 784 F.2d 224, 226 (6th Cir. 1986) (EPA acted arbitrarily in using a model to set emission limits 'without adequately validating, monitoring, or testing its reliability or its trustworthiness in forecasting pollution [...]"); *Boucher v. U.S. Suzuki Motor Corp.*, 73 F.3d 18 (2nd Cir. 1996) (excluding expert testimony under Rule 702). "In each of these cases, the Court has recognized the impact of calibration on the model integrity." *Abarca*, 761 F. Supp. 2d at 1060 n.55.

The Commission's model also uses overstated forecasted market prices, rather than available forward energy prices that represent actual market transactions (and which the Commission utilized in AEP Ohio's *ESP II* case), overstating the energy credit by more than $50/MW-day. (AEP Ohio AFR at 27-28, Appx. at 33-34.) It also uses understated fuel costs for AEP Ohio's coal generation units that bear no rational relationship to the Company's actual historical fuel costs, resulting in an energy credit overstatement of more than $70/MW-day. (*Id.* at 32-35, Supp. at 38-41.) And it uses incorrect heat rates that do not reflect how AEP Ohio's generation resources actually operate, and which ignore the heat rate data for each resource that is readily available in the Company's FERC Form 1. (*Id.* at 35-38, Supp. at 41-44.) This leads to an energy credit overstatement of $1.87/MW-day. (*Id.* at 36, Supp. at 42.)

The Commission did not address any of these flaws. In response to all of AEP Ohio's concerns, the Commission stated only: "[W]e do not believe that the Company has demonstrated that the inputs actually used by EVA are unreasonable." *Capacity* Order at 35, IEU Appx. at 79. Given the record and the Commission's total failure to substantively address the host of problems with the energy credit, the Court should not defer to the Commission's methodology. Instead, the Court should remand the energy credit to the Commission with instructions to correct it and to modify AEP Ohio's capacity rate accordingly.

<u>Proposition of Law No. IX</u>: Precluding AEP Ohio from recovering the difference between its cost of capacity and the auction rate would constitute a regulatory taking.

OCC argues that the Commission "is not authorized to permit a utility to defer for collection from retail electric customers the difference between the utility's costs of capacity and the wholesale discounted rate it charges marketers." (OCC Br. 20.) Doing so, OCC asserts, would "create[] an unlawful subsidy" from retail customers to CRES providers, who only pay the auction price for capacity. (*Id.* at 21.) That argument is incorrect. *See* Prop. V.B.2, *supra*, at 35-36. But even if OCC were correct, precluding AEP Ohio from recovering the difference would violate the U.S. Constitution's Takings Clause. *See* U.S. Const. amend. V.

In *Penn Central Transportation Co. v. New York City*, 438 U.S. 104 (1978), the Supreme Court established three factors to determine whether a government action constitutes a regulatory taking: (1) the economic impact of the regulation; (2) the extent to which the regulation interfered with investment-backed expectations; and (3) the character of the regulation. *Id.* at 123; *see also Goldberg Cos., Inc. v. Richmond Hts. City Council*, 81 Ohio St.3d 207, 211, 690 N.E.2d 510 (1998) (applying *Penn Central*). If a decision by this Court were to allow the Commission to impose auction-based pricing with no deferral recovery mechanism, the State would need to provide AEP Ohio just compensation as a matter of federal constitutional law.

With respect to the economic impact of the regulation, AEP Ohio offered extensive witness testimony regarding the pernicious economic effect that a non-compensatory capacity price has. (*See, e.g.*, AEP Ohio Exs. 101-104, Supp. at 1-249.) The Commission agreed "that RPM-based capacity pricing would be insufficient to yield reasonable compensation." *Capacity* Order at 23, IEU Appx. at 67. AEP Ohio likewise offered testimony regarding the certainty to investors provided by a cost-based state compensation mechanism and the uncertainty associated with an auction-based rate. (*See* AEP Ohio Ex. 101 at 9, Supp. at 9.) And no investor's expectations would be met if a utility commission has the authority to find that a rate is just and reasonable but then prevent the party generating capacity from recovering anything close to that rate. Finally, the character of the government regulation would likewise compel an order of just compensation. Any order by the Commission that stripped AEP Ohio of its ability to recover reasonable compensation would go well beyond "some public program adjusting the benefits and burdens of economic life to promote the common good." *Penn Central*, 438 U.S. at 124. It would *harm* the public good by removing any incentive to develop new capacity. OCC's request to cancel any deferment should be rejected. If it is accepted, this Court should rule that "just compensation" (the difference between AEP Ohio's capacity costs and the auction-rate) is owed to AEP Ohio.

CONCLUSION

For the foregoing reasons, the Court should reject Appellants' challenges and grant the relief that Cross-Appellant seeks.

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IN THE SUPREME COURT OF OHIO

INDUSTRIAL ENERGY USERS – OHIO,	:	Consolidated Case Nos. 2012-2098 2013-0228
Appellant,	:	Appeals from the Public Utilities Commission of Ohio
v.	:	
THE PUBLIC UTILITIES COMMISSION OF OHIO,	:	Public Utilities Commission of Ohio Case No. 10-2929-EL-UNC
Appellee.	:	

APPENDIX TO MERIT BRIEF OF APPELLEE/CROSS-APPELLANT OHIO POWER COMPANY

INDEX TO APPENDIX

ORIGINAL

IN THE SUPREME COURT OF OHIO

INDUSTRIAL ENERGY USERS - OHIO	:	**Case No. 2013-228**
Appellant	:	**Appeal from the Public Utilities Commission of Ohio**
v.	:	
THE PUBLIC UTILITIES COMMISSION OF OHIO,	:	**Public Utilities Commission of Ohio Case No. 10-2929-EL-UNC**
Appellee.	:	

NOTICE OF CROSS-APPEAL OF OHIO POWER COMPANY

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NOTICE OF CROSS-APPEAL OF OHIO POWER COMPANY

Cross-Appellant, Ohio Power Company ("OPCo"), hereby gives notice of its cross-appeal, pursuant to R.C. 4903.13 and Supreme Court Rule of Practice 10.02(A)(3), to the Supreme Court of Ohio and Appellee, the Public Utilities Commission of Ohio ("Commission" or "PUCO"), from an Opinion and Order entered on July 2, 2012 (Attachment A), an Entry on Rehearing entered October 17, 2012 (Attachment B), an Entry on Rehearing entered December 12, 2012 (Attachment C), and an Entry on Rehearing entered January 30, 2013 (Attachment D) – all in PUCO Case No. 10-2929-EL-UNC. That case involved the Commission's determination of the rate that OPCo may charge its retail competitors, Competitive Retail Electric Service or "CRES" providers, for generation capacity resources that OPCo supplies to them. This cross-appeal is filed within sixty days of the Commission's December 12, 2012 Entry on Rehearing.

OPCo is a party in PUCO Case No. 10-2929-EL-UNC and timely filed an Application for Rehearing of the Commission's July 2, 2012 Opinion and Order in accordance with R.C. 4903.10. OPCo raised each of the assignments of error listed below in its July 20, 2012 Application for Rehearing.

Appellant, the Industrial Energy Users – Ohio (IEU) initiated this appeal one week after the January 30, 2013 Entry on Rehearing (Attachment D), which was the second appeal instituted by IEU from the case below (the other appeal is Case No. 2012-2098). Consequently, there is a question as to whether the December 12, 2012 Entry on Rehearing (Attachment C) or the January 30, 2013 Entry on Rehearing (Attachment D) finalized the Commission's decision for purposes of appeal before this Court . The Commission filed a motion to dismiss Case No.

2012-2098 on January 18, 2013 and OPCo filed a motion to dismiss this appeal on February 21, 2013, both of which remain pending. In sum, there is uncertainty as to which decision of the Commission was a final order for purposes of appeal and, by extension, which appeal before this Court is proper and should go forward. Consequently, Cross-Appellant/Appellee also filed a separate notice of cross-appeal in Case No. 2012-2098.

The Commission's July 2, 2012 Opinion and Order, October 17, 2012 Entry on Rehearing, December 12, 2012 Entry on Rehearing and January 30, 2013 Entry on Rehearing (collectively, the "Commission's Orders") are unlawful and unreasonable in the following respects:

I. The Commission's Orders unreasonably and unlawfully understate OPCo's cost of providing generation capacity resources to CRES providers because the energy credit that the Commission applied to reduce OPCo's cost-based capacity rate is unreasonably and unlawfully overstated.

a. The energy credit that the Commission adopted is unreasonably and unlawfully overstated because it is based on a static shopping assumption that is lower than, and not reflective of, the amount of shopping taking place at the time of the hearing, the amount of shopping taking place on the date of the Commission's Order, or the amount of shopping that is currently occurring.

b. The energy credit that the Commission adopted is unreasonably and unlawfully overstated, is based on a host of fundamental technical and calculation errors, and is against the manifest weight of the evidence. *Inter alia*, the methodology used to calculate the energy credit does not withstand basic scrutiny and is largely a "black box;" it was not properly calibrated; it did not utilize the correct forward energy prices; it utilized inaccurate and understated fuel costs; it did not utilize the correct heat rates to capture minimum and start time operating constraints and associated cost impacts; it wrongly incorporates off-system sales margins; it fails to properly reflect the operation and impact of the AEP System Interconnection Agreement; and it overstates OPCo's relevant forecasted future gross margins.

II. The Commission's Orders are confiscatory, unjust, and unreasonable, and they result in an unconstitutional taking of OPCo's property without just compensation. *Fed. Power*

Comm. v. Hope Natural Gas Co., 320 U.S. 591 (1944); *Penn Central Transp. Co. v. New York City*, 438 U.S. 104, 124 (1978).

WHEREFORE, Cross-Appellant Ohio Power Company respectfully submits that the Commission's July 2, 2012 Opinion and Order, October 17, 2012 Entry on Rehearing, December 12, 2012 Entry on Rehearing and January 30, 2013 Entry on Rehearing are unlawful, unjust, and unreasonable and should be reversed in the respects outlined above. The case should be remanded to the Commission to correct the errors complained of herein.

Respectfully submitted,

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Amendment V to the Constitution of the United States

No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

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

APPLICATION FOR REHEARING OF OHIO POWER COMPANY

Pursuant to Section 4903.10, Ohio Revised Code ("R.C."), and Rule 4901-1-35, Ohio Administrative Code ("O.A.C."), Ohio Power Company ("AEP Ohio" or the "Company") respectfully files this Application for Rehearing of the Commission's July 2, 2012 Opinion and Order. The Commission's July 2, 2012 Opinion and Order is unreasonable and unlawful in the following respects:

I. The Energy Credit That The Commission Adopted In The July 2 Opinion and Order Is Unreasonable And Unlawful.

   A. The Commission's adoption of a $147.41/MW-day energy credit based upon Staff's static assumption of 26.1% shopping throughout the 2012-2015 period is flawed. According to Staff's own witness, the energy credit should be lower based upon the established shopping level of 30% as of April 30, 2012. And the energy credit should be even substantially lower based upon the increased levels of shopping that will occur with RPM pricing.

   B. There are a host of fundamental errors in EVA's energy credit that the Commission adopted in the July 2 Opinion and Order, causing the resultant energy credit to be patently unreasonable and against the manifest weight of the evidence.

      1. EVA's methodology does not withstand basic scrutiny and is largely a "black box."

      2. EVA failed to calibrate the model or otherwise account for the impact of zonal rather than nodal prices.

3. EVA erred in forecasting LMP prices instead of using available forward energy prices, especially given Staff's position in the Modified ESP proceeding that lower forward energy prices should be used for the MRO test.

4. The record shows that EVA used inaccurate and understated fuel costs.

5. EVA failed to use correct heat rates to capture minimum and start time operating constraints and associated cost impacts.

6. EVA's energy credit wrongly incorporates traditional OSS margins and otherwise fails to properly reflect the impact of the Pool.

   a. *The adopted energy credit erroneously reflects more than OSS margins created by "freed up" energy associated with the capacity being paid for by CRES providers.*

   b. *The adopted energy credit imputed a fictional market-based margin attributable to 100% of the non-shopping load and incorporated that into the energy credit to offset the charge for shopping load, which not only creates an unreasonable and unlawful subsidy, but also confiscates margin that AEP Ohio is authorized to retain through its SSO rates.*

   c. *The adopted energy credit unlawfully fails to reflect operation of the FERC-approved Pool in its inflated energy credit.*

7. EVA's estimate of gross margins that AEP Ohio will earn in the June 2012 through May 2015 period are overstated by nearly 200%, as shown by AEP witness Meehan's alternative calculation of forecast gross margins.

8. At a minimum, the Commission should conduct an evidentiary hearing on rehearing to evaluate the accuracy of EVA's energy credit compared to actual results.

C. The Commission's adoption of an energy credit that incorporates actual costs from the 2010 test period and then imputes revenues that have no basis in actual costs creates a state compensation mechanism that is unconstitutionally confiscatory and that results in an unconstitutional taking of property without just compensation.

   1. The Commission's Order is confiscatory, unjust, and unreasonable under the "end result" standard of *Hope Natural Gas*.

2. The Commission's Order results in an unconstitutional partial taking of AEP Ohio's property without just compensation under the *Penn Central* standard.

II. It Was Unreasonable And Unlawful For The Commission To Adopt A Cost-Based State Compensation Mechanism And Then Order AEP Ohio To Only Charge CRES Providers RPM Pricing Far Below The Cost-Based $188.88/MW-Day Rate That The Commission Determined Was Just And Reasonable.

A. If the state compensation mechanism is cost-based and the Commission found AEP Ohio's cost of providing capacity to be $188.88/MW-day, then it is unreasonable and unlawful for the Commission to require AEP Ohio to charge anything other than $188.88/MW-day.

B. It was unreasonable and unlawful for the Commission to authorize AEP Ohio to collect only RPM pricing and require deferral of expenses up to $188.88/MW-day without simultaneously providing for recovery of the shortfall.

C. It is unreasonable and unlawful for the Commission to require AEP Ohio to supply capacity to CRES providers at a below-cost rate to promote artificial, uneconomic, and subsidized competition.

D. It was unreasonable and unlawful, as well as unnecessary, for the Commission to extend RPM pricing to customers that switched at a capacity price of $255/MW-day.

E. It was unreasonable and unlawful for the Commission to rely critically on the policies set forth in R.C. 4928.02 and 4928.06(A) to justify reducing CRES providers' price of capacity after the Commission found that R.C. Chapter 4928 does not apply to AEP Ohio's capacity charges to CRES providers.

III. It Was Unreasonable And Unlawful For The Commission To Fail To Address The Merits Of AEP Ohio's January 7, 2011 Application For Rehearing, Which The Commission Granted On February 2, 2011 For The Purpose Of Further Considering It, In The July 2 Opinion and Order.

A memorandum in support of this Application for Rehearing is attached.

Respectfully submitted,

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On behalf of Ohio Power Company

MEMORANDUM IN SUPPORT

INTRODUCTION

The Commission's July 2, 2012 Opinion and Order ("July 2 Opinion and Order") was unreasonable and unlawful in numerous respects and should be reversed and modified on rehearing. Although the Commission correctly determined that AEP Ohio is entitled to receive cost-based, not RPM-based, compensation for the capacity that it is required to supply to competitive retail electric service ("CRES") providers, the cost-based capacity charge that the Commission arrived at in its July 2 Opinion and Order is seriously and unreasonably understated. That is because the Commission adopted an unreasonable and unlawful energy credit, sponsored by Staff, that reduces the capacity charge by an unreasonable amount that cannot be supported.

As an initial matter, the Commission utterly failed, with respect to the energy credit, to meaningfully set forth any reasons or facts upon which its adoption of the energy credit is based, in derogation of its responsibilities under R.C. 4903.09. Instead, the Commission merely characterized the myriad flaws in the energy credit, and AEP Ohio's extensive cross examination, testimony, and evidence correcting those flaws, as merely amounting to "a fundamental difference in methodology" and went on to find that Staff's approach was "proper" and "produces an energy credit that will ensure that AEP-Ohio does not over recover its capacity costs." July 2 Opinion and Order at 36.

This treatment of the numerous flaws and issues present in the Staff's energy credit was insufficient as a matter of law and did not address any of the following significant problems with the Staff's approach: (1) The adopted energy credit is inappropriately and unreasonably based upon a static shopping assumption of 26.1% shopping throughout the 2012-2015 period, despite the fact that shopping presently exceeds, and will continue to increasingly exceed, that percentage in the future. (2) The adopted energy credit is patently unreasonable because it is a "black box" incapable of meaningful evaluation, the model used to calculate it was uncalibrated and failed to account for the impact of zonal prices, it unreasonably uses overstated forecasted LMP prices instead of available forward energy prices, it incorporates inaccurate and understated fuel costs, it uses incorrect heat rates, and it wrongly incorporates traditional OSS margins and fails to properly reflect the impact of the AEP System Interconnection Agreement ("Pool"). (3) The adopted energy credit creates a state compensation mechanism that is unconstitutionally confiscatory and that results in an unconstitutional taking of property without just compensation.

Moreover, the Commission's decision to adopt a cost-based state mechanism and then nonetheless order the Company to charge CRES providers RPM pricing was unreasonable and unlawful. First, if the state compensation mechanism is to be cost-based, as the Commission determined, then the Commission lacks authority to order the Company to charge a non-cost-based rate. Second, the Commission's decision is unreasonable and unlawful for ordering the Company to defer the difference between the $188.88/MW-day cost-based rate and the RPM without simultaneously providing a mechanism for the Company to recover that shortfall. Although this case and Case No. 11-346-EL-SSO address interrelated issues, the Commission may not assign an issue that must be decided in this proceeding to another proceeding with an independent case schedule and rehearing and appeal processes. Moreover, the Commission's decision unreasonably and unlawfully enables and promotes artificial, uneconomic, and subsidized competition at the Company's expense. The decision also unreasonably and unnecessarily extends RPM pricing to customers who shopped based on capacity priced at $255/MW-day, depriving the Company of its contract-based expectations. And the

Commission's justification for its decision to order the Company to recover only RPM pricing – state policies set forth in R.C. 4928.02 and 4928.06(A) – was unreasonable and unlawful as well, because the Commission expressly determined in its July 2 Opinion and Order that R.C. 4928 is *inapplicable* to AEP Ohio's capacity service.

Finally, the Commission's July 2 Opinion and Order unreasonably and unlawfully failed to address the merits of the Company's January 7, 2011 application for rehearing, which the Commission granted in February 2011 for further consideration but never addressed on its merits. These significant errors, individually and in the aggregate, compel the Commission to grant rehearing and correction.

BACKGROUND

The factual and procedural history of this proceeding is lengthy and need not be repeated in its entirety here, however, the following background is pertinent to the issues raised in the Company's application for rehearing. Under the Fixed Resource Requirement ("FRR") provisions in the PJM Interconnection, L.L.C. (PJM) Reliability Assurance Agreement (RAA), AEP Ohio is obligated to provide capacity resources sufficient to support all shopping load in its service territory through May 31, 2015. The initial default charge that AEP Ohio collected for providing this essential service was based on PJM's RPM capacity auction prices. AEP Ohio realized in 2010 that RPM pricing established for the 2012-2015 period would not permit the Company to recover anything close to the full amount of its costs of providing capacity to support shopping.

Accordingly, in November 2010, consistent with the provisions in the RAA and its rights established by the Federal Power Act (FPA), AEP Ohio proposed to implement an existing clause within the RAA to change the basis of compensation for use of its capacity by CRES providers to an AEP Ohio cost-based method.[1] This application was intended to remedy the situation where CRES providers were receiving a subsidy from AEP Ohio for their use of the Company's capacity due to the use of RPM auction prices.

In response to AEP Ohio's November 2010 application to the FERC, the Commission represented to FERC that as of December 8, 2010, it was "adopt[ing] as the state compensation mechanism for the Companies the current capacity charges established by the three-year capacity auction conducted by PJM," which is the PJM RPM auction price.[2] *See* Case No. 10-2929-EL-UNC, Entry at 2 (Dec. 8, 2010). AEP Ohio applied for rehearing of the Commission's December 8, 2010 Entry on January 7, 2011. In its application for rehearing, AEP Ohio argued, *inter alia*, that:

- The Commission's Entry establishing an interim wholesale capacity rate was unreasonable and unlawful because the Commission is a creature of statute and lacks jurisdiction under both Federal and Ohio law to issue an order affecting wholesale rates regulated by the Federal Energy Regulatory Commission.
- The Entry was issued in a manner that denied AEP Ohio due process and violated statutes within Title 49 of the Revised Code, including Sections 4903.09, 4905.26, and 4909.16, Revised Code.
- The Entry directly conflicts with, and is preempted by, federal law and therefore should be reversed and modified.

(*See* Jan. 7, 2011 App. for Rehearing.) On February 2, 2011, the Commission granted AEP Ohio's application for rehearing of the December 8, 2010 Entry, finding that "sufficient reason has been set forth by AEP Ohio to warrant further consideration of the matters specified in the

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[1] On November 2, 2010, AEP Ohio filed an application with the FERC in FERC Docket No. ER11-1995-000. On November 24, 2010, at the direction of FERC, AEP Ohio refiled its application in FERC Docket No. ER11-2183-000.

[2] At the time of the Commission's December 8, 2010 Entry, CRES providers were paying AEP Ohio $220/MW-day as the then-current RPM price.

application for rehearing." Case No. 10-2929-EL-UNC, Entry on Rehearing at 2 (Feb. 2, 2011). That rehearing request remains pending.

In an August 11, 2011 Entry, the Commission established an initial procedural schedule for the hearing necessary to establish an evidentiary record on a state compensation mechanism. A number of parties intervened in this proceeding, and many have taken the position that the Commission should require AEP Ohio to charge only the uncompensatory RPM-based price to CRES providers for the capacity it supplies them. The evidentiary hearing commenced on April 17, 2012, and concluded on May 15, 2012. The parties filed initial post-hearing briefs on May 23, 2012, and reply briefs on May 30, 2012. The Commission issued its Opinion and Order deciding the merits of the case on July 2, 2012.

ARGUMENT

I. The Energy Credit That The Commission Adopted In The July 2 Opinion and Order Is Unreasonable And Unlawful.

The Commission's adoption of Staff's proposed energy credit without meaningful explanation or analysis violates R.C. 4903.09. Moreover, the adopted energy credit is seriously flawed in several respects: It is inappropriately and unreasonably based upon a static shopping assumption of 26.1% shopping throughout the 2012-2015 period, despite the fact that shopping presently exceeds, and will continue to increasingly exceed, that percentage in the future; it is a "black box" incapable of meaningful evaluation, the model used to calculate it was uncalibrated and failed to account for the impact of zonal prices, it unreasonably uses overstated forecasted LMP prices instead of available forward energy prices, it incorporates inaccurate and understated fuel costs, it uses incorrect heat rates, and it wrongly incorporates traditional OSS margins and fails to properly reflect the impact of the Pool; and it creates a state compensation mechanism that is unconstitutionally confiscatory and that results in an unconstitutional taking of property without just compensation. For all of these reasons, the energy credit that the Commission adopted in the July 2, 2012 Opinion and Order is unreasonable and unlawful and should be corrected on rehearing.

A. The Commission's adoption of a $147.41/MW-day energy credit based upon Staff's static assumption of 26.1% shopping throughout the 2012-2015 period is flawed. According to Staff's own witness, the energy credit should be lower based upon the established shopping level of 30% as of April 30, 2012. And the energy credit should be even substantially lower based upon the increased levels of shopping that will occur with RPM pricing.

EVA's method for calculating the energy credit offset to embedded costs relies upon, as a principal factor, the level of shopping that exists during the period that the energy credit is being applied. In this case, that period is the term of the proposed ESP. EVA assumed a shopping level of 26.1%, which was the level of shopping as of March 31, 2012, to establish its energy credit offset. (Staff Ex. 105 at 19; AEP Ohio Ex. 142 at 21.) Since then, the level of shopping has increased substantially. Company witness Allen testified on rebuttal that, as of April 30, 2012, the level of shopped load had increased to 30.19%. (AEP Ohio Ex. 142 at 21.) Moreover, the record and the Commission's findings show that the level of shopping will increase significantly based on RPM pricing. Thus, the energy credit needs to be reduced accordingly if EVA's energy credit methodology is to be retained on rehearing.

There is no question that under EVA's energy credit, if shopping goes up above 26%, CRES providers would pay a higher net capacity charge. (Tr. X at 2190-91.) Ms. Medine's direct testimony was very explicit about this relationship under EVA's energy credit model:

> An increase in the switching assumption will tend to decrease the energy credit while a decrease in the switching assumption will tend to increase the energy credit.

(Staff Ex. 105 at 19.) Ms. Medine testified that EVA assumed 26% shopping throughout the 2012-2015 period, for purposes of calculating the energy credit. (Tr. X at 2189.) She confirmed that the 26% static shopping assumption was "the most conservative approach" that could be used and Ms. Medine has no knowledge or expertise about projected shopping levels. (*Id.* at 2194.) Use of a 26% shopping assumption going forward in the context of RPM pricing is absurd and has no basis in the record.

Indeed, the Commission itself explicitly recognizes and manifestly intends that the adopted RPM pricing "will stimulate true competition among suppliers in AEP Ohio's service territory." July 2 Opinion and Order at 23. The Commission also made a specific finding that RPM pricing would yield "an unusually low return on equity of 7.6 percent in 2012 and 2.4 percent in 2013, with a loss of $240 million between 2012 and 2013." *Id.*) And AEP Ohio witness Allen projected financial harm based on shopping level assumptions of 65% for residential, 80% for commercial and 90% for industrial customers (excluding a single large customer) by the end of 2012. (AEP Ohio Ex. 104 at 4-5.) Mr. Allen's workpapers, admitted into the record as evidence, also support the projected shopping level under RPM pricing of 71.3%. (*See also* RESA Ex. 102 at 3 ((16,942 GWh + 17,490 Gwh)/(48,261 GWh)=71.3%).)

Thus, the Commission's observations about the anticipated financial harm of RPM pricing is supported by testimony of record that incorporates elevated shopping levels based on RPM pricing. That is the same record evidence that supports the Commission's ultimate finding that adopting RPM pricing "will stimulate true competition among suppliers in AEP Ohio's service territory." July 2 Opinion and Order at 23. As it stands now, there is an inconsistency between the Commission's recognition that RPM pricing will cause shopping to increase (indeed that was the premise for adopting RPM pricing) and the Commission's adoption of EVA's energy credit methodology without an adjustment for higher shopping levels, which adjustment EVA itself testified would need to be done.

As the testimony of AEP Ohio witness Nelson demonstrated, the impact of increased levels of shopping (above the assumed 26.1% level) on the EVA-proposed energy credit and, thus, on the net embedded cost capacity price is substantial. With an increase in the shopping level from 26% to 50%, the Staff's energy credit declines by $27/MW-day (from $152 to $125/MW-day); with an increase to a 75% shopping level, the energy credit declines by $56/MW-day (from $152 to $96/MW-day); and with an increase to a 100% shopping level, the energy credit is reduced by $85/MW-day (from $152 to $67/MW-day). (AEP Ohio Ex. 143 at 7.) Even at the 30.19% level that had already been achieved by April 30 – well before the impact of the Commission's July 2, 2012 decision to reduce capacity pricing to prevailing RPM prices – the erroneous impact on the Staff's energy credit of that level of increased shopping, from 26.1%, is significant.

Specifically, there is a direct impact on the net capacity price of an increased shopping level under EVA's approach (*i.e.*, a decreased energy credit used to offset the demand charge is an increase in the net capacity cost). Accordingly, at the 50% shopping level the net capacity cost increases from $188.88/MW-day to $215.88/MW-day; at a 75% shopping level, the net capacity cost increases to $245.13/MW-day; and at 100% shopping, the net capacity cost, under the Staff's methodology, increases to $274. (AEP Ohio Ex. 143 at 7.) Even the approximately 4% increase in shopping that occurred from March 31 (26.1%) to April 30 (30.19%), would correspond to a decreased energy credit, under the Staff's methodology, of approximately $4.50, and an increase in the net capacity cost of the same amount (resulting in a net capacity cost of $193.30), which is still a significant increase from the $188.88 figure that is based on clearly erroneous assumption of 26.1% shopping. Indeed, using the data included in AEP Ohio witness

Nelson's table on page 7 of AEP Ohio Ex. 143, for every 1% increase in shopping, Staff's energy credit decreases by $1.15/MW-day (($67/MW-day - $152/MW-day) / (100%-26%)).

The impact of the level of shopping on the energy credit the Commission has adopted in its July 2 Opinion and Order thus is a significant variable that should, at a minimum, account for actual shopping levels as of date of the Commission's decision. Moreover, the evidence of record and the Commission's own findings indicate that shopping levels will substantially increase under the RPM pricing regime. The Commission's energy credit, however, fails to reflect these changes in shopping. This failure unreasonably decreases the amount of capacity revenue that the Company will receive. On rehearing, the energy credit based on EVA's methodology should be decreased substantially in order to correctly reflect realistic shopping levels during the term of the ESP.

B. There are a host of fundamental errors in EVA's energy credit that the Commission adopted in the July 2 Opinion and Order, causing the resultant energy credit to be patently unreasonable and against the manifest weight of the evidence.

In its Opinion and Order, the Commission dismisses AEP Ohio's legitimate objections to the energy credit calculated by Staff as merely a disagreement over two competing methodologies or approaches, saying:

> Upon review of all of the testimony, the Commission finds that it is clear that the dispute between AEP-Ohio and Staff *amounts to a fundamental difference in methodology* in everything from the calculation of gross energy margins to accounting for operation of the pool agreement. AEP-Ohio claims that Staff's inputs to the AURORAxmp model result in an overstated energy credit, while Staff argues that the Company's energy credit is far too low. *Essentially, AEP-Ohio and Staff have simply offered two quite different approaches in their attempt to forecast market prices for energy.*

July 2 Opinion and Order at 36 (emphasis added).

If Staff's methodology for calculating the energy credit was, in fact, a defensible approach using defensible inputs, which just happened to result in a different numerical outcome than the Company's equally defensible approach, then the Commission could properly select either approach to determine an appropriate energy credit, much like courts must sometimes choose between alternative and equally legitimate formulas to calculating prevailing parties' damages or attorneys' fees. Indeed, the Ohio Supreme Court has previously deferred to the Commission's selection of one among multiple *defensible* methodologies or formulas. In *Ohio Edison Co. v. Pub. Util. Comm.*, 173 Ohio St. 478, 184 N.E.2d 70 (1962), for example, at issue was the proper formula to use for the allocation of property and expenses, and the Supreme Court stated:

> This question as to the proper method of allocation is a controversial problem. *** No one formula is proper for all cases.
> ***
> The statutes nowhere specify a formula for allocation. *Hence, as long as the method chosen by the commission is not unreasonable, this court should not disturb it. Thus, the question is not whether the method proposed by Ohio Edison is the best method but whether the method of allocation used in this case by the commission is reasonable.*

Id. at 483-84 (emphasis added).

There may in fact be more than one way to calculate an energy credit, if the Commission insists on applying an energy credit here to reduce the Company's cost of capacity.[3] There may even be more than one *reasonable* approach to calculating an energy credit. But the problem here is that the Commission did not simply make a permissible choice among reasonable

[3] Although the Company did not recommend, in the first instance, that there be an energy credit offset to the cost-based capacity price, Company witness Pearce made a recommendation for how such an energy credit could be devised, and the methodology for calculating the energy credit engendered perhaps the most debate at the hearing. (AEP Ohio Ex. 102 at 13-20. *See generally* Tr. II at 253-534 (Company witness Pearce); Tr. IX at 1813-2102 (Staff witnesses Harter and Smith); Tr. X at 2123-2252 (Staff witness Medine); Tr. XI at 2329-2539 (Company witness Allen); Tr. XII at 2612-2278 (Company witnesses Nelson and Meehan).)

approaches, as it did in the *Ohio Edison* case quoted above. Instead, it unreasonably chose to adopt Staff's invalid approach, which resulted in a grossly overstated energy credit (and, in turn, a grossly understated capacity cost). As we all know from very recent history, the Ohio Supreme Court will not hesitate to reverse the Commission's orders in circumstances where the Court doubts the reliability or reasonableness of a methodology or model that is applied to derive a given result. *See In re Application of Columbus Southern Power Co.*, 128 Ohio St.3d 512, 2011-Ohio-1788, 947 N.E.2d 655, ¶ 25-26 (rejecting the Black-Scholes model as a formula supporting AEP's POLR charge).

The Commission should grant the Company's application for rehearing to address the fundamental deficiencies in Staff's approach to deriving its energy credit in order to avoid facing another reversal and remand from the Supreme Court, because these deficiencies are simply too pervasive and troubling for a reviewing court to ignore. *See, e.g., Tongren v. Pub. Util. Comm.*, 85 Ohio St.3d 87, 89, 1999-Ohio-206 ("'The General Assembly never intended this court to perform the same functions and duties as the Public Utilities Commission but it did intend that this court should determine whether the facts found by the commission lawfully and reasonably justified the conclusions reached by the commission *** and whether the evidence presented to the commission as found in the record supported the essential findings of fact so made by the commission.'"), *quoting Commercial Motor Freight, Inc. v. Pub. Util. Comm.*, 156 Ohio St. 360, 363-64, 102 N.E.2d 842 (1951). For the reasons that follow, Staff's methodology for calculating its energy credit was fundamentally flawed in multiple respects beyond the inaccurate shopping assumption already described above. For the following additional reasons, in adopting Staff's flawed approach, the Commission abdicated its statutory duty to make reasonable findings and conclusions concerning the energy credit that are supported by the weight of the evidence. R.C. 4903.09.

1. EVA's methodology does not withstand basic scrutiny and is largely a "black box."

In its initial post-hearing brief (at 43), AEP Ohio explained the straightforward template for an energy credit that Dr. Pearce presented in Exhibits KDP-1 through KDP-4 of his Direct Testimony. (AEP Ohio Ex. 102.) Dr. Pearce's calculation of the energy credit relies upon a fair and reasonable proxy for the energy revenue that CSP and OPCo (and, thus, the merged entity) could have obtained by selling equivalent generation into the market. (*Id.* at 15.) The cost basis for the energy under Dr. Pearce's approach is computed using the same formula rates described for the capacity rate calculation that he sponsored, providing for a consistent and straightforward solution to deriving an energy credit. (*Id.* at 16.) As AEP Ohio explained in its initial post-hearing brief:

> One of the principal benefits of the energy credit approach that Dr. Pearce recommends, if one is to be used, is that *it relies upon the same cost data that underlies the capacity cost rate*. In addition, because it is updated annually to reflect the most current FERC Form 1 data, the cost data will be very closely aligned with the period during which the capacity rate and energy credit are applied to establish the applicable price for capacity.

(AEP Ohio Initial Br. at 45 (emphasis added).) Given that the Commission expressly found that Dr. Pearce's formula rate template is an "appropriate starting point for determination of its capacity costs," July 2 Opinion and Order at 33, the Commission's decision to then part ways from Dr. Pearce's template-based approach to calculating the energy credit becomes all the more puzzling.

Relying on the testimony and exhibits presented at the hearing, AEP Ohio went on in its post-hearing brief to contrast Dr. Pearce's straightforward approach with the flawed approach utilized by Staff. First, as the Company noted in its post-hearing brief (at 45), the cross-examination of the Staff/EVA witness (Harter) who sponsored Staff's energy credit revealed a number of errors in the implementation of, and the results produced by, Staff's energy credit methodology. These *acknowledged* errors required Staff to quickly request permission from the Commission to present supplemental testimony from a brand-new Staff/EVA witness (Medine) to try to correct those errors and bolster the methodology and energy credit that Mr. Harter had developed. Staff resorted to filing an expedited motion for additional time in the procedural schedule of the hearing to try to correct what Staff itself described as "*significant, inadvertent errors in estimating the energy credits* presented in Staff's testimony submitted by Ryan T. Harter." (Staff's May 1, 2012 Expedited Motion at 2) (emphasis added.) The schedule that the Commission entered in granting Staff's expedited request left the Company just three business days between the supplemental "clean up" testimony of Staff witness Medine and the due date for the Company's rebuttal testimony. (May 3, 2012 Entry at 3.) In the Company's rebuttal testimony, Mr. Allen described how the errors by Staff's energy credit witnesses resulted in multiple proposed energy credit figures being proposed at various times over the course of these proceedings:

> During the course of the hearing Staff witnesses presented three different versions of their calculation of an energy credit to apply in determining an appropriate capacity charge rate as well as three different sets of work papers. The initial calculation was revised twice to address errors that were identified prior to and during the hearing.

(AEP Ohio Ex. 142 at 3-4.)

Notably, in its July 2 Opinion and Order adopting Staff's energy credit, the Commission fails to mention the troubling procedural issues occasioned by the "significant, inadvertent errors" committed by the witness who originally sponsored Staff's energy credit. These errors

and the rushed "correction" that followed certainly called into question the reliability of the methodology that the Commission ultimately adopted. But even putting aside the procedural irregularities associated with Staff's original and supplemental energy credit witnesses, AEP Ohio demonstrated that Ms. Medine only partially, and superficially, corrected the errors in the calculations that Mr. Harter initially sponsored.

As a threshold matter, the Commission should grant rehearing on the energy credit issue because EVA's modeling approach cannot be meaningfully evaluated or tested by others, due to the "black box" nature of EVA's methodology. For example, while both Staff witnesses testified that modeling is only as good as the inputs, and that bad data inputted into the model results in inaccurate results coming out of the model (Tr. IX at 1851; Tr. X at 2244), Mr. Harter testified that all of the data used in the model was either off-the-shelf from the software developer's default database or developed by others at EVA besides Mr. Harter, so that he could not answer questions about it. (Tr. IX at 1865.) He was therefore unable to testify about the vintage of the data used in the model (*id.* at 1873-74); the coal forecast data (which was handled by a different team at EVA) (*id.* at 1844); or the reserve margin that was used in the model. (*Id.* at 1872.) Harter and Medine could not even agree on whether heat rate inputs were or were not customized as part of the Aurora modeling. (Tr. X at 2151, 2158-59.)

AEP Ohio witness Meehan, a Senior Vice President at NERA with more than thirty years of experience in the field, reviewed Harter and Medine's testimony and modeling results and concluded that "[t]he approach used by EVA is impossible to verify as it is produced by a 'black box approach' that cannot be examined for errors." (AEP Ohio Ex. 144 at 6.) Mr. Meehan provided compelling testimony in support of this conclusion, none of which is addressed by the Commission in its July 2 Opinion and Order. Specifically, Mr. Meehan described some of the missing information that made it impossible to assess the critical inputs into the Aurora model utilized by Staff to calculate the energy credit, saying:

> First, *no data has been provided on the Aurora model inputs.* What units are in and are out, what zones are they in, what is the load by zone, what is the load shape by zone, what units are must run, how is unit commitment done in each zone, what transmission links are modeled, what are the heat rates for all modeled units, what are the fuel costs, what are the emission characteristics and many more data items are critical inputs and choices. *These are all necessary inputs that EVA would have had to review and decide on and no information is provided in the EVA work papers regarding them.* Second, the way in which Aurora takes market price data and AEP unit data is neither described nor shown. Complete data would be appropriate, but not even an example for an hour or month is provided. Third, a limited set of data is provided for AEP Ohio units. But it is missing important detail. Monthly gross revenues and cost are not provided and variable O&M assumptions are not provided. *The work papers are completely unsuitable to assess the analysis and only useful in that even this limited set shows errors that demonstrate that EVA has grossly overstated gross margins for AEP Ohio units.*

(*Id.* at 13-14) (emphasis added.) Next, Mr. Meehan went on to testify why these missing pieces resulted in an unverifiable "black box":

> **Q. CAN THE MODEL AND DATA USED BY EVA BE REASONABLY VERIFIED?**
>
> A. No, *the model and data are essentially a black box approach. EVA has not supplied a complete set of model inputs or a description of its workings and there is no testimony offered as to the logical structure of the model.* Models like Aurora are general and provide the user with many modeling options. My experience and expectation as a witness who on numerous occasions has testified to production cost model applications has been that I would describe and be available for cross examination on how the model worked and what options I had selected, would provide a complete data set and be available for cross examination on the data, provide a User's Manual, and describe and be available for cross examination on calibration efforts. *While certain information may require a confidentiality agreement, it would be made available so that the model and data were not a black box.* EVA has only provided some of the data it has used for AEP Ohio

> units. It has described but not provided the data from the firm's FUELCAST data set or any detail regarding the Aurora data customized by EVA. There is simply no way to examine the reasonableness of the analysis or assumptions used to develop the market prices other than to conduct a parallel analysis. *There may well be numerous errors or inappropriate uses of the model, but that cannot be seen or tested with the information provided.*

(*Id.* at 15-16) (emphasis added.)

Mr. Meehan also testified that Staff witness Medine's supplemental "clarifications" to Mr. Harter's earlier, admittedly erroneous testimony provided precious little in the way of new information, which did nothing to open and unpack Staff's model from its inscrutable black box:

> Ms. Medine notes several things. First, she states that EVA has been fine tuning the model for 6 months. Second she states that EVA has populated the model with every U.S. electric power generating unit. Third she states that EVA incorporated its view of plant additions and retirements. Fourth she states that EVA applied proper load characteristics for each energy market. Fifth she states that EVA incorporated its own delivered fuel price forecast by plant and its own emission allowance forecasts. *Virtually no detail is supplied as to any of these items.* *** No data for any non-AEP Ohio plant is provided, no description of how the various sources are combined is included, and no description of any quality control procedures is given. *Despite this attempt to add clarity, no useful information to review or judge what EVA's individual view of coal price forecasts is available. It is still a black box.* She concludes that, "Many of the individual pieces of information are used for model input validation and/or aggregated to levels that are congruent with the modeling structure." Yet she provides not a single example of validating one piece of fuel cost data for any non-AEP Ohio unit nor any description of the "modeling structure." She then testifies that she uses "EVA's quarterly natural gas price forecast derived from analyzing gas well production data for each U.S. natural gas play in combination with EVA's assessment of future natural gas demand." *But no data are provided. All we have is a single proprietary natural gas forecast that can't be examined or tested. Despite her alleged clarifications the inputs remain a black box.*

(*Id.* at 20-21 (emphasis added).)

Given these strongly-worded critiques of Staff's "black box" approach, one would expect that Staff would have cross-examined Mr. Meehan on these issues at the hearing, in an attempt to rehabilitate EVA's approach and demonstrate that its modeling of an energy credit was indeed supported by reliable and verifiable inputs. But when Staff cross-examined Mr. Meehan, it largely avoided the topic. Staff asked about the circumstances of Meehan's engagement, and about AEP's relationship with Meehan's employer, NERA. (Tr. XII at 2754-56.) Staff asked if Mr. Meehan could explain the difference between forward price curves and forecasts, and Mr. Meehan reiterated that forward-market prices are the best forecasts of future market prices (another flaw in Staff's approach discussed separately, *infra*). (*Id.* at 2756-58.) When asked by Staff whether the proprietary nature of certain model inputs makes it "difficult to fully examine and validate that information," Mr. Meehan *disagreed*, testifying that the proprietary nature of certain model inputs (which are provided in workpapers) should not result in an unverifiable process like the one undertaken by EVA. (*Id.* at 2760.) Staff cross-examined Mr. Meehan about some other issues, including emission allowances, heat rate curves, operating costs, and coal prices, but Staff never directly challenged Mr. Meehan on the fundamental criticisms that he lodged against Staff's unverifiable, "black box" approach. (*Id.* at 2761-76.)

In its post-hearing reply brief, Staff attempted to do so (at 17), asserting that "EVA's methodology is not a black box model," but Staff justified this conclusory assertion with irrelevant points that do not address Mr. Meehan's fundamental criticisms. For example, in support of its conclusion that EVA's methodology was not a "black box," Staff asserted in its reply brief (at 17) that "Mr. Harter and Ms. Medine worked together as a team in gathering the input data" – an assertion that does nothing to rebut Mr. Meehan's critique that key inputs were not shared with AEP Ohio or otherwise verifiable. In the same paragraph, Staff asserted that Ms.

Medine "is an expert fuel analyst" and that "EVA properly calibrated the model." Again, however, these assertions do not address Mr. Meehan's point that critical inputs were not shared and remain unverifiable.

The legitimate criticisms that AEP Ohio witness Meehan lodged against Staff's "black box" approach to calculating an energy credit were thus essentially unrebutted by Staff at hearing and on brief; nor were these criticisms addressed by the Commission in its July 2 Opinion and Order. The Commission should grant the Company's Application for Rehearing to address the fundamental concerns that Mr. Meehan raised in his testimony regarding Staff's "black box" approach to calculating a grossly overstated energy credit. Because the Commission agreed that the Company's formula rate template was "an appropriate starting point for determination of its capacity costs," July 2 Opinion and Order at 33, but then applied Staff's grossly overstated energy credit (instead of the energy credit as calculated by Dr. Pearce) to reduce the capacity charge by such a significant amount, these fundamental criticisms of EVA's approach should not have been swept under the rug, as they have been to date. EVA's unverifiable modeling approach will not survive the scrutiny of a reviewing court, particularly given the Ohio Supreme Court's recent decision in *Columbus Southern Power*, where the Court sent a clear message that models or formulas proposed by parties to Commission proceedings, if adopted by the Commission, must accurately and verifiably provide adequate record support for the Commission's conclusions. 2011-Ohio-1788 at ¶ 25-26.

2. EVA failed to calibrate the model or otherwise account for the impact of zonal rather than nodal prices.

Another critical failing related to the Staff/EVA Aurora model used to support the energy credit relates to calibration. As Mr. Meehan explained in his testimony, calibration of any forecasting model is essential to ensure accuracy – it is the "most basic step" in any modeling analysis, and one that Staff's witnesses admittedly failed to perform here:

> *The most basic step in any large scale production cost model analysis is to calibrate the results of the model that will be used to a known measure. That does not appear to have been done by EVA.* For example, one would compare the forecast of market prices that the model and data set are producing on and off peak to available forward market data at the AEP/Dayton hub *** [.] If one could determine that the model and data were consistently overstating prices by say 5%, the model results could be reduced by that amount. *** Alternatively, one could do a backcast with the model and see how well the model reproduces prices at the AEP generation hub. This is called a benchmark and is extremely time consuming. Mr. Harter has not discussed these and to my understanding has testified that he has only made two runs of the model for this case, which tends to confirm that he did not develop a calibration or benchmark in the context of the analysis being performed in this case. Ms. Medine also does not mention the results of any such effort in her written testimony. *** Without calibrating the results and knowing whether they accurately reflect reality, it is inappropriate to use model results. *The failure to perform and describe the results of any type of calibration exercise reinforces the unsuitability of the methodology used by EVA.*

(AEP Ohio Ex. 144 at 10-11) (emphasis added; internal citations to the record omitted.) As Mr. Meehan went on to explain, this failure to undertake a meaningful calibration exercise was more than just a "process" mistake. He testified that, had an appropriate calibration exercise been performed, he is confident that it would have revealed significant impacts on the gross margin calculated in EVA's final run, to which Ms. Medine testified – impacts on the order of "well over 20%." (AEP Ohio Ex. 144 at 12.)

> This means that even if EVA were to have all AEP Ohio unit operating costs correct, it would be overstating margins by at least 20%. As I will discuss below EVA does not have all such costs correct, which leads to an even greater overstatement of energy margins. *The overriding point with respect to methodology is that a calibration effort, if properly done and extended to consider zonal and nodal price differences, could have possibly substituted in part for the inability to validate all input assumptions.*

> *However, no such evidence of any such effort has been provided and no calibration factor has been used.*

(*Id.* at 12-13) (emphasis added.)

Mr. Meehan confirmed multiple times during cross-examination that the failure to calibrate the model outputs against actual market results was one of his most significant criticisms of the Staff/EVA approach to calculate an energy credit. (Tr. XII at 2706, 2716.) He also confirmed on re-direct that if the administratively determined energy credit was based on a formula approach such as the one Dr. Pearce conducted on behalf of the company, based on actual embedded costs, the results "should already be calibrated." (*Id.* at 2777-78.) In other words, as he testified, calibration is "inherent" in the use of either forward prices or actual embedded costs. (*Id.* at 2718.) Yet again, Staff avoided the topic of calibration in its cross-examination of Mr. Meehan, did not redirect Ms. Medine on the topic, and the Commission likewise avoided the topic in its July 2 Opinion and Order.

In its post-hearing reply brief, Staff asserted that "EVA properly calibrated the model through running the model 'hot' using updated forecasts and pricing information, and a sensitivity test." (Staff Br. at 17, *citing* Tr. X at 2209-2211.) But this citation by Staff was misleading, because in the very same pages of the transcript cited by Staff in its post-hearing reply brief, Ms. Medine confirmed that the model "*was not recalibrated.*" (Tr. X at 2210-2211 (emphasis added).) Moreover, in the same section of the transcript cited by Staff, Ms. Medine tried to rely on another engagement for the government (which she testified she was "not allowed" to discuss) as the source of other model runs that were used to "make some changes." (*Id.* at 2209-2210.) When asked later if "there were any results of the first run model that was presented to the Commission *** that caused you to want to go back and calibrate or tweak any of the data or run it again," Ms. Medine answered simply "no." (*Id.* at 2163.) She deferred to

Mr. Harter as the "best person to ask about that." (*Id.* at 2164.) The claim that EVA properly calibrated the model is simply not credible and distorts the record established in this proceeding. EVA did not present a single shred of evidence to show that the model had been calibrated at all for the projection of LMPs in this case, let alone that the calibration was proper or sufficient. The reality is that EVA's one full-time modeler (Mr. Harter) simply did not have the time to properly calibrate the model (due to EVA's late engagement by Staff for this case) and thus took unacceptable short-cuts. In sum, as the Company set forth in its post-hearing reply brief, the claim that EVA sufficiently calibrated the model that was used to calculate Staff's energy credit must be rejected for the following reasons:

- Staff did not present any quantitative evidence comparing EVA's model results to either historical LMPs or forward prices.
- In attempting to present EVA's calibration efforts in the best possible light, Staff, as described above, resorted to mischaracterizing Ms. Medine's testimony regarding whether (or not) any true calibration took place.
- The LMP's produced by EVA's AURORAxmp model are 8% above current forward prices at the AEP Dayton hub.
- An 8% overstatement in market prices will overstate gross margins by well over 20%, all else equal, thus reflecting an inadequate calibration.
- Adequate calibration is impossible, as EVA only produced zonal prices. Ms. Medine testified that this was fine as there was no intra zonal congestion, but Mr. Meehan provided data showing that, in fact, there was significant intra zonal congestion and that the use of zonal prices is evidence of inadequate calibration.

(AEP Ohio Ex. 144 at 24-26.)

Courts have long recognized the critical necessity of properly calibrating any model that is used to support an adjudicative determination. Only last year, for example, the United States District Court for the Eastern District of California, in a case regarding alleged exposure to contaminants migrating from a manufacturing site, noted that "it is undisputable that calibration is a 'critical' and 'valuable' step that ensures that model simulation matches the field observation to a reasonable degree." *Abarca v. Franklin County Water Dist.*, 761 F.Supp.2d 1007, 1060 (E.D. Cal. 2011). The *Abarca* court further noted that the importance of calibrating model results to actual data "is not limited to the field of groundwater modeling" and that appellate courts "*throughout the United States have emphasized calibrating/harmonizing model predictions with actual data to ensure reliability.*" *Id.* at n. 55 (emphasis added), *citing Eleven Line, Inc. v. North Texas State Soccer Assn., Inc.*, 213 F.3d 198, 206-8 (5th Cir. 2000) (antitrust context); *Inland Empire Public Lands Council v. Schultz*, 992 F.2d 977, 982 (9th Cir. 1993) (noting that agency conducted "extensive field investigations to calibrate and verify its models."); *Sterling v. Velsicol Chem. Corp.*, 855 F.2d 1188, 1199 (6th Cir. 1988) ("The plaintiffs carefully devised, calibrated, and tested their model, based upon physical data generated by Velsicol's own consultants, to determine the physical and chemical characteristics beneath the landfill."); *Ohio v. United States Environmental Protection Agency*, 784 F.2d 224, 226 (6th Cir. 1986), reaff'd, 798 F.2d 880, 881 (6th Cir. 1986) (holding that the EPA acted arbitrarily in using a model to set emission limits 'without adequately validating, monitoring, or testing its reliability or its trustworthiness in forecasting pollution [...]"); *Boucher v. U.S. Suzuki Motor Corp.*, 73 F.3d 18 (2nd Cir. 1996) (excluding expert testimony under Rule 702). As the *Abarca* court explained, "[i]n each of these cases, the Court has recognized the impact of calibration on the model integrity." *Abarca*, 761 F.Supp.2d at 1060, n. 55.

For these reasons and those already presented to the Commission in the Company's post-hearing briefing (left unaddressed in the July 2 Opinion and Order), it is evident that EVA failed to properly calibrate the model that it used to calculate Staff's proffered energy credit. The Commission's approval of an energy credit that resulted from this uncalibrated model was unreasonable. Such an approach is unlikely to survive scrutiny from a reviewing court, especially because the disputed energy credit dwarfs the actual historical revenue data presented in the record. Rehearing, therefore, should be granted, and the Staff's erroneously calibrated model should be disregarded.

3. EVA erred in forecasting LMP prices instead of using available forward energy prices, especially given Staff's position in the Modified ESP proceeding that lower forward energy prices should be used for the MRO test.

The use of overstated market prices in the Staff/EVA approach to calculating an energy credit is yet another fundamental flaw that Mr. Meehan and Mr. Allen addressed in their testimony. This flaw is yet another topic that the Commission failed to address in its Opinion and Order (other than briefly reciting the Company's position on the matter, at p. 28), and it had a significant and material effect on the energy credit proffered by Staff and adopted by the Commission.

As Mr. Meehan testified, forward energy prices are the market's collective view of the most likely price outcome—they represent real money committed to *actual* market transactions by *actual* buyers and sellers. (AEP Ohio Ex. 144 at 14.) The forward energy price "reflects the consensus that the market has reached." (*Id.*) "The only view that represents a price that is current and can be transacted is at the market view or forward price." (*Id.*) Another key advantage of using forward prices is that they are "not subject to the whim of potential errors or inconsistencies in thousands of input data items or limitations in model capabilities." (*Id.*)

> The forward price can be observed and represents the consensus view of many market participants. Using a forward price eliminates the need to construct a forecast from thousands of unverifiable inputs and to calibrate for things which a model cannot measure. These items are all embedded in the forward market price.

(*Id.* at 14-15.) Despite these inherent advantages embodied in forward prices, Staff/EVA declined to use them to calculate the energy credit. Instead, Staff/EVA applied overstated forecasted market prices. Mr. Allen explained the staggering consequences of using overstated forecasted market prices instead of forward market prices:

> A comparison of the market prices used in Staff witnesses Harter and Medine's analysis to publically available forward prices for the AEP Zone shows that *their market prices are overstated by over $4/MWh over the three-year forecast period.* Overstated market prices will have the impact of overstating the margins produced by the generating resources of AEP Ohio and, as a result, will overstate the energy credit calculated by Staff.
>
> ***
>
> *I have estimated that the use of current forward market prices for the AEP zone would have reduced Staff witness Harter's energy credit by $50.42/MW-day.*

(AEP Ohio Ex. 142 at 8-9 (emphasis added).) Mr. Allen included this analysis in Exhibit WAA-R4. (*Id.*)

As the Company explained in post-hearing briefing, there are glaring inconsistencies between the method used by Staff witness Smith in developing the demand charge, versus the work done by witnesses Medine and Harter in developing the energy credit. (AEP Ohio Initial Br. at 54-57; AEP Ohio Reply Br. at 19-20.) Whereas Staff's demand charge was developed using 2010 *actual* cost data, Staff's energy credit was based on *projected* energy margins calculated with overstated market price forecasts. (AEP Ohio Initial Br. at 54-55.) Ms. Medine readily conceded this difference in the following exchange:

> Q. Mr. Smith used actual data when he developed the demand charge, did he not?
>
> A. Right, and we were doing – he is doing his cost based, and we are trying to come up with an energy credit so they are different analyses.
>
> Q. They don't use the same method even though you are netting them against each other, correct?

A. Correct.

(Tr. X at 2171.)

There are also glaring inconsistencies between the approach of Staff here in the capacity case, versus its insistence on using forward market prices in the Modified ESP case for the MRO test. In the Modified ESP case involving the same 2012-2015 time period that Staff used to project an energy credit, Staff witness Johnson's testimony uses the PJM forward market to establish a lower energy price and a more restrictive MRO test. *See* Case No. 11-346-EL-SSO, *et al.*, Prefiled Testimony of Daniel R. Johnson (filed May 9, 2012.) Put another way, in early May of this year, Staff gladly used forward market prices to make it more difficult for the Company to pass the ESP/MRO test. Only *days* before, in contrast, Staff's witness Medine submitted her testimony in this case, declining to use forward market prices in the energy credit calculation that she and witness Harter sponsored for Staff. Staff simply cannot have it both ways, and its rejection of forward market prices here can only be seen as a result-oriented selection of whatever methodology would reduce the capacity charge by the greatest possible extent. *Accord, State v. Pub. Util. Comm.*, 344 S.W.3d 349, 361 (Tex.2011) (Supreme Court of Texas ordering Public Utility Commission on remand in true-up proceedings to apply "actual sale" method to determine market value, rather than other methods that could be used to determine market value "indirectly;" noting that actual sale in a "bona fide third-party transaction on the open market" provides the "best measure" of market value.)

AEP Ohio witness Meehan provided the following apt summary of why his market-data based approach is superior to the approach that EVA utilized here with its overstated market price forecasts:

> To claim otherwise is the height of arrogance. If EVA had forecasting skills that were reliably superior to the market, it would

> be irrational for the firm to provide client services as they do. The rational thing to do would be to take proprietary market positions and trade using their superior insight.

(AEP Ohio Ex. 144 at 26-27.)

When counsel for Staff attempted to cross-examine Mr. Meehan on his understandable preference for the use of forward prices, Mr. Meehan confirmed the obvious superiority in his approach, as reflected in the following exchange at hearing:

> Q. Okay. Mr. Meehan, can you explain the difference between a forward-price curve and a forecast?
>
> A. Yes.
>
> Q. What is the difference?
>
> A. *A forward price is something that's observed in the market, it's a buyer and a seller. It's quoted. It's traded, business transacts at it.* A forecast is sort of a person's view of what the – of what market will be in the future. Usually based on some type of modeling exercise.
>
> Q. So you would agree then that a forward-price curve reflects on what parties may be willing to transact today for a date and a time in the future but may not necessarily reflect that – that market price in the future?
>
> A. I think both – I mean, neither a forward price nor a forecast is going to reflect the price in the future. The price in the future is going to change from what you would forecast or project with a *** forward-market price at this time. *I think a forward-market price is the best forecast of the market price in the future.*
>
> Q. *So is it your testimony that the only reliable number to use in the analysis of the energy credit in this case is the forward-price curve power?*
>
> A. *More or less, yes. I mean, I think if a forward price exists for a product or commodity, as I say in my testimony, I think it's sort of arrogant to say you have a forecast that's better than that. If you do, you probably should be out trading, not – not testifying.*
>
> Now there is a lot of reasons for a model – model provides more information if you're looking at fuel consumption, fuel usage, or comparing alternatives. But when a forward price is available, I think it is generally superior to a view of the market developed from a forecast.

(Tr. XII at 2756-57 (emphasis added).) In spite of the clear advantages to utilizing forward prices, Staff witness Medine steadfastly maintained her view that it is better in this case to rely on her subjective judgment than to rely on actual forward contract data reflecting negotiated market prices. (Tr. X at 2168.) The Commission should examine this portion of Ms. Medine's cross-examination closely. Her responses to questions about why forward prices were *not* applied are hardly convincing. They betray an inexplicable preference for *forecasting* a key component of the energy credit calculation that would be more accurately reflected by *actual forward prices*:

> Q. Why not use actual forward prices that are out there for this kind of a short term?
>
> A. *Because forward prices, you know, are forward prices. They're not forecasts* and so there is a relationship between a forecast and a forward price but a forward price is simply what you or I would agree to do today to buy power or coal or whatever two years from now.
>
> *And we believe it's more accurate to use a fundamental forecast rather than a forward price curve of any kind* – anything but sort of the prompt period and if you do the analysis of the forward price curves, you know that forward price curves *** move on a dime. If the forward price today is $50, you know, prompt year plus one will be 52, 54, and a month from now it will go to 60, 62, 64. They go up and down with the wind, with the weather, with everything. *So we just don't believe that the *** forward price curve is the way to go.*

(*Id.* at 2166 (emphasis added).) If the Commission buys into this kind of unconvincing (at times, bordering on nonsensical) justification for relying on a price *forecast* instead of known forward prices, then it is abdicating its duty to ensure that Staff's proffered energy credit – which the Commission adopted in its Opinion and Order – is reasonably supported by reliable evidence in the record. Further, if the Commission applied the same logic in administering the MRO test under R.C. 4928.143(C), it would use higher prices based on such projections – which it has not done. In sum, because there is no apparent, reasonable explanation for maintaining the absurd position that *predicted* (and overstated) market prices are superior than *actual forward prices* when it comes to calculating the energy credit (other than to support overstated energy margins that would, in turn, result in lowering the capacity charge), the Commission should grant rehearing and adjust Staff's energy credit accordingly, based on the application of reliable forward prices.

4. The record shows that EVA used inaccurate and understated fuel costs.

As the Commission noted in its July 2 Opinion and Order (at 28), the Company also objected to Staff's energy-credit calculation on the basis that it understates fuel costs for coal units. The Company detailed this objection at pages 57-60 of its initial post-hearing brief, replete with citations to the record, and again in its reply brief (at pages 29-30.) The Commission, however, failed to specifically address this objection before concluding (at 34) that Staff's recommended energy credit is "reasonable." For the reasons that follow, the Commission should grant rehearing to address the understated fuel costs (costs that Staff witness Medine herself conceded on cross-examination were "certainly aggressive" (Tr. X at 2288-89)) that Staff/EVA incorporated into the energy credit calculation.

AEP Ohio witness Allen noted several troubling understatements of fuel costs during his review of Harter and Medine's energy-credit calculations. For example, Mr. Allen reviewed EVA's fuel cost data for Gavin Units 1 & 2 (AEP Ohio's largest generation resources) and noted that the fuel cost data for these units understated actual 2011 fuel costs by over $5/MWh ($390 million, based upon the Staff witnesses' projected generation for these units). (AEP Ohio Ex. 142 at 5.) Although Ms. Medine testified on cross-examination that "anomalous events" at the Gavin plant contributed to this discrepancy, Mr. Allen disagreed, noting that the one-time payment Ms. Medine referred to was booked to fuel expense in 2008 and had no bearing on the

2011 actual fuel costs that he reviewed for comparison purposes. (*Id.*) **Mr. Allen conservatively[4] estimated that the use of more reasonable fuel costs would have significantly reduced Staff's energy credit by $70/MW-day.** (*Id.* at WAA-R1.) Mr. Meehan discovered the same fundamental fuel cost error in his review of EVA's analysis, saying:

> EVA has understated operating costs for many AEP Ohio generating units. One obvious example if the Gavin plant where EVA uses approximately $14/MWH for fuel costs while the actual fuel cost calculated by data supplied by AEP for the June 2012 to May 2015 period is expected to be approximately $24/MWH. As EVA projects Gavin to generate over 60 TWH (terawatt-hours), the impact on margin of this single fuel costs error, all else equal, is an overstatement of margins by at least $600 million. This is just from the fuel cost error for one plant.

(AEP Ohio Ex. 144 at 16.) Mr. Meehan also took issue with Staff/EVA's attempts to defend, instead of correct, this very substantial fuel cost error. He explained:

> There may well be many other errors in the EVA Aurora database – but there is no reason to believe that these other errors offset the impact of the error in Gavin fuel cost. EVA, by defending and not correcting the very substantial Gavin fuel cost error, is asking us to believe that its gross margins are correct because if it corrected all errors in the model, the market price would change by the exact same amount that it has understated Gavin fuel costs. This is preposterous. *** Hence, it is implausible, illogical and unreasonable to believe that energy margin results are made more accurate by ignoring the error in the assumptions regarding the cost of AEP Ohio units, in particular Gavin's fuel costs, than by fixing it. The correct thing to do is to fix known errors not ignore them. *** Also note that the Gavin error is not the only fuel costs error. It is just the fuel cost error with the most impact.

(*Id.* at 19-20.)

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[4] Mr. Allen's approach, using 2011 actual fuel costs as the point of reference for evaluating the amount by which EVA's fuel cost assumptions are understated for the ESP period, is very conservative because, in fact, the fuel costs for coal units is escalating during the time period in accordance with the terms of the coal contracts that will provide most of the fuel for the plants. (Tr. XI at 2460-2461.)

Again, in spite of these strong criticisms regarding the very significant fuel cost errors underlying its energy credit calculation, Staff devoted precious little briefing and argument to the issue in its post-hearing briefs. In its initial brief, for example, on the subject of fuel cost inputs to the model, Staff asserted only that:

> Mr. Allen also acknowledged from Staff Exhibit 108 (EIA Short-Term Energy Outlook Released May 8, 2012) that EIA forecasts the average delivered coal price in 2012 will be 2.8% lower than the 2011 average price and the average delivered coal price in 2013 will be 3.8% lower than 2012. This outlook supports Staff witness Medine's modeled forecast and analysis with respect to coal prices.

(Staff Initial Br. at 63.) But this assertion by Staff, and its reliance on Staff Exhibit 108, is simply wrong. As AEP Ohio explained succinctly in its post-hearing reply brief:

> Staff also argues (at 63) that Mr. Allen acknowledged from Staff Exhibit 108 *** that EIA forecasts the average delivered coal price in 2012 will be 2.8% lower than the 2011 average price, and the average delivered coal price in 2013 will be 3.8% lower than 2012. Staff suggests that this outlook supports Ms. Medine's modeled forecast and analysis with respect to coal prices. On the contrary, the forecasted drop in coal prices are for *spot purchases*, and AEP already has contracts in place for most of its coal needs. (Tr. XI at 2430-2431.) Staff Exhibit 108 does not in any way lend credibility to EVA's grossly understated fuel costs.

(AEP Ohio Reply Br. at 29 (emphasis in original).)

Tellingly, Staff did not rely on its Exhibit 108 again in its reply brief. Instead, Staff defended the understated fuel cost inputs by asserting that:

> EVA did not change or manipulate any fuel cost data, which was customized and reflected EVA's latest input assumptions, when operating and running its Aurora model for this engagement and analysis. Therefore, EVA committed no bias with its model results. *** Mr. Meehan further testified that he did not review any coal contracts for Gavin because he relied on AEP Ohio for cost data. AEP Ohio witness Allen acknowledged that the short term energy outlook published recently by the U.S. Department of Energy states that the average delivered coal price is declining

> from 2011 to 2012, and again in 2013. Mr. Meehan agreed under cross examination that fuel costs are very important to the analysis of gross margins. He also agreed that if AEP Ohio is overstating fuel costs then his or AEP Ohio's gross margins would be understated.

(Staff Reply Br. at 18-19.) But these assertions by Staff in reply do not solve the significant problems that AEP Ohio identified with respect to the fuel cost inputs to the Staff/EVA model. The fact that EVA did not "manipulate" fuel cost data does not solve EVA's failure to use the correct data inputs in the first place, such as the correct inputs for the Gavin plant. The fact that Mr. Meehan did not review any coal contracts for Gavin is also immaterial – the Commission may review them itself on rehearing if it has any reason to doubt what those contracts say. And the fact that DOE's outlook for average coal price is declining is immaterial when it is uncontroverted that AEP Ohio already has coal contracts in place for most of its coal needs. (Tr. XI at 2430-31.) EVA's cost assumptions bear no rational relationship to actual historical costs and the Commission failed to meaningfully address these flaws in its July 2 Opinion and Order. For all of the foregoing reasons, and for the reasons previously set forth in AEP Ohio's post-hearing briefs, the Commission should grant rehearing to adjust Staff's energy credit based on EVA's inaccurate and understated fuel costs.

5. EVA failed to use correct heat rates to capture minimum and start time operating constraints and associated cost impacts.

Still another significant flaw in Staff's energy credit that merits rehearing relates to EVA's failure to apply correct heat rate data. AEP Ohio discussed this flaw in detail at pages 60-64 of its initial post-hearing brief, including multiple citations to the record. Again, while acknowledging this objection by the Company (at page 28 of its July 2 Opinion and Order), the Commission made no specific findings or conclusions related to it. The Commission apparently dismissed this concern as part and parcel of its unsupported determination that Staff's recommended energy credit is "reasonable." July 2 Opinion and Order at 34, 36.

The crux of the heat-rate problem meriting rehearing is that EVA assumed that each of the Company's generating units either operates at its full-load heat rate or is offline. (Staff Ex. 105 at 10-11.) Staff itself confirmed this fact in its initial post-hearing brief, saying "EVA chose to use the EPIS default heat rate at which each generation unit could operate (also known as full output heat rate)." (Staff Initial Br. at 50.) *Thus, there is no dispute in the record about the heat rate data that Staff's consultants utilized in their energy credit model.*

EVA chose this expedient route after an internal debate about whether to customize heat rate data. (Tr. X at 2151.) As Company witness Allen explained, even though actual heat rate data for AEP's units is "publicly and readily available" on pages 402 and 403 of the Company's FERC Form 1s, EVA chose the wrong approach after this internal debate and "significantly understated the heat rates of the plants/units." (AEP Ohio Ex. 142 at 7.) As he testified:

> I have estimated that the use of correct actual heat rates for the gas fired generation resources would have reduced Staff's energy credit by $1.87/MW-day. This analysis is included in Exhibit WAA-R3. The impact of these heat rate errors on the coal units is included in the fuel cost analysis I previously discussed so I have not separately calculated the impact here. The understated heat rates that Staff witnesses Harter and Medine used for the gas fired generation resources of AEP Ohio results in overstated margins.

(AEP Ohio Ex. 142 at 8.) Company witness Meehan agreed with Mr. Allen that EVA modeled the energy credit using flawed heat rates, explaining:

> The point is that *the model developer's claim that it is appropriate to use full load heat rates and have units be at full capacity or off is wrong and has been offered without any context supporting the specific application of the model.* Large steam units simply cannot run that way. Many of AEP's large steam units are supercritical units *** that have minimum up and down times of 72 hours. If the unit is economic over this cycle it will run and it will be

> profitable during the day, but to achieve these profits it will have to run at minimum load over the night period and sustain losses that will offset its daytime profits. *The failure to model with correct minimum up and down times, to model a heat rate at minimum load, and to only reflect the full load heat rate and turn AEP's coal units on and off with no regard for minimum up and down times, is a fatal flaw in modeling unit profits.*

(AEP Ohio Ex. 144 at 22-23 (emphasis added).) Mr. Meehan went on to explain that while it may have been "simpler" for EVA to model this way, it is "inadequate" and unrealistic for EVA to assume that "the units can be turned off and on at the flip of a switch." (*Id.* at 23.) Mr. Meehan estimated that EVA's failure to properly model operational constraints for the coal-fired generating units resulted in an overstatement of gross margins by $256 million, all else equal. (*Id.* at 30.)

Staff witness Medine ultimately acknowledged that using optimal heat rates does not capture the minimum run operation or start times, and she also admitted that EVA had not done the modeling for AEP Ohio using anything approaching an average heat rate. (Tr. X at 2246.) She further acknowledged that the table on page 12 of her testimony shows that even the largest plant, Gavin station, does not run 20% of the time and, therefore, it cannot experience the optimal heat rate. Similarly, the Cardinal plant does not run about 20% of the time and the heat rate she used for Cardinal was 5% less than the average heat rate recently experienced at the plant. (*Id.* at 2243-2246, 2250.) Ultimately, she agreed that in EVA's analysis, the costs are understated and the projected margins are overstated through the use of optimal heat rates, because start costs and minimum run costs are not reflected. (*Id.* at 2255-2256.)

Given these undisputed facts in the record relating to EVA's use of flawed heat rate data in the Aurora model, it is not surprising that Staff, in its post-hearing reply brief, glosses over the issue, without any citations to the record whatsoever, saying, "EVA's efficient heat rate application was correctly used and applied for this analysis. Simply because AEP Ohio finds the results disadvantageous does not make EVA's method, analysis, and results wrong." (Staff Reply Br. at 19-20.) Respectfully, if the Commission is going to choose Staff's energy credit methodology instead of the Company's, then it must demand from Staff a far more meaningful and robust response than this one to legitimate criticisms that the Company has developed on the record through the supplemental testimony of multiple witnesses.[5] EVA's "method, analysis, and results" *are indeed wrong* for their failure to correctly model known and undisputed operational constraints, which resulted in an overstatement of gross margins by $256 million, all else equal. (AEP Ohio Ex. 144 at 30.)

6. EVA's energy credit wrongly incorporates traditional OSS margins and otherwise fails to properly reflect the impact of the Pool.

As described above, the Commission's July 2 Opinion and Order, at 29, characterizes Staff's/EVA's energy credit's incorporation of OSS margins not associated with shopping, imputation of a market-based margin for non-shopping customers, and failure to properly reflect the operation of the FERC-approved Pool of which AEP Ohio is a member, as well as AEP Ohio's reasoned refutation of those fundamental errors during cross-examination, in rebuttal testimony, and in post-hearing briefs, as "differences in methodology." Like the other errors discussed above, however, EVA's errors with respect to OSS margins and the Pool in calculating the energy credit, and the Commission's unreasonable adoption of EVA's flawed methodology with regard to those issues, do not amount to "differences in methodology." They represent clear errors in the Staff's methodology and they warrant correction on rehearing.

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[5] *Compare, United States v. Ohio Edison Co.*, 276 F.Supp.2d 829, 879 (S.D. Ohio 2003) (in rejecting the defendants' contention that a government expert had ignored projected and actual heat rate improvements in his emissions calculations, the district court noted that "Dr. Rosen examined monthly heat rate and utilization factors for each of the Sammis units" before rendering his conclusions).

a. The adopted energy credit erroneously reflects more than OSS margins created by "freed up" energy associated with the capacity being paid for by CRES providers.

Under the approach that the Commission adopted in setting the energy credit established in its July 2 Opinion and Order, it is assumed that AEP Ohio's Member Load Ratio ("MLR") share (currently 40%) of all OSS margins are retained and available to offset costs of capacity furnished to CRES providers. The approach does not offset those capacity costs with only AEP Ohio's retained energy margins from "freed up" OSS sales; rather, in addition to those margins, it also commandeers retained margins from unrelated OSS sales (*i.e.*, traditional OSS margins).

As the Company explained in its post-hearing briefs, an energy credit operating to reduce the price of capacity that is supplied to CRES providers should not include an offset for OSS margins not associated with the capacity being paid for to support shopping load. (AEP Ohio Initial Br. at 69-76; AEP Ohio Reply Br. at 31-34.) Indeed, such an offset is unreasonable because non-shopping retail customers do not receive such an offset. Moreover, the Commission determined that a cost-based mechanism should be adopted; therefore, imputing a hyper-inflated margin conflicts with the Commission's stated intention.

If the Commission does find it necessary to offset the energy credit based on OSS margins, it should certainly not appropriate the margins retained by AEP Ohio that are independent of the capacity supplied to CRES providers. CRES providers and their customers should not have an OSS margin credit when retail customers do not. Thus, if the energy credit must account for OSS margins, only those attributable to "freed up" energy associated with the capacity being sold to a CRES provider should be included. The energy credit should not also confiscate AEP Ohio's traditional OSS margins, which exist independent of any sale of capacity to CRES providers. The Commission's July 2 Opinion and Order, however, disregarded AEP

Ohio's arguments on this point and unreasonably adopted an energy credit which strips from the Company its traditional OSS revenues without meaningfully addressing these objections. This error should be corrected on rehearing and, to the extent any OSS margins are included as an offset in determining the energy credit, only those margins actually attributable to "freed up" energy should be used.

b. The adopted energy credit imputed a fictional market-based margin attributable to 100% of the non-shopping load and incorporated that into the energy credit to offset the charge for shopping load, which not only creates an unreasonable and unlawful subsidy, but also confiscates margin that AEP Ohio is authorized to retain through its SSO rates.

The Commission's adoption of Staff/EVA's erroneous energy credit methodology also inappropriately attributes fictional market-based margin to 100% of nonshopping load and incorporates that attribution into the energy credit to offset the capacity charge for CRES providers. Specifically, Staff assumed that 100% of the retail energy margins that it imputed are available, and Staff used them to offset the cost of capacity furnished to CRES providers. As the Company explained in post-hearing briefing, this was patently unreasonable, and the Commission's July 2 Opinion and Order, which adopts this methodology, is likewise unreasonable.

As an initial matter, Staff did not explain why any, let alone why all of its imputed retail SSO margins should be co-opted for the benefit of CRES providers. The improper imputation of 100% non-shopping margins also mathematically dilutes the impact of the Pool, based on an arbitrary and capricious inclusion of *non-shopping margin* in the energy credit calculation relating to the price of capacity *for shopping load*. AEP Ohio's SSO pricing has been, and is being, established through separate proceedings involving the distinct ESP regulatory regime; SSO pricing and SSO margins therefore have no place in the energy credit calculations related to shopping load. (*Id.* at 74.) Thus, the Commission's decision adopting Staff's improper methodology unlawfully confiscated non-shopping SSO revenues by commingling them with OSS margins used to develop the wholesale capacity charge for CRES providers. In addition to violating the FERC-approved Pool Agreement and the Federal Power Act, the Commission's adoption of a methodology that funds a capacity charge discount through the use of SSO revenues also amounts to a subsidy of a competitive service and, therefore, conflicts with Ohio's energy policy and basic economic principles.

c. ***The adopted energy credit unlawfully fails to reflect operation of the FERC-approved Pool in its inflated energy credit.***

In addition to the perverse impact that the Commission-adopted methodology of imputing 100% of non-shopping SSO margins as an offset to CRES providers' capacity costs has in improperly inflating the energy credit, the methodology also unlawfully disregards the correct operation of the FERC-approved Pool. Company witness Nelson explained that imputing non-shopping SSO energy margins as "Retail Margins" and then providing 100% of that margin to CRES providers effectively increases the MLR from an actual 40% (the level that AEP Ohio is required to retain under the Pool) to about 92% (a level not permitted by the Pool). (AEP Ohio Ex. 143 at 10.) This approach greatly overstates the amount of margin that AEP Ohio can retain under the FERC-approved AEP Pool Agreement and provides a windfall to CRES providers, particularly at the low level of shopping that Staff has assumed. (*Id.* at 10-11; AEP Ohio Initial Br. at 73.) The Pool is under the FERC's jurisdiction and infringement upon its operation is preempted by federal law. (*See* AEP Ohio Ex. 143 at 2); *Mississippi Power & Light,* 487 U.S. 354, 357, 108 S.Ct. 2428 (1988); *American Electric Power Service Corp.,* 32 FERC ¶ 61,363 (1985). In substance, this flawed method confiscates revenues from AEP Ohio's retail SSO sales and uses them to subsidize CRES providers through a lower wholesale rate that they pay to AEP

Ohio for capacity. (AEP Ohio Ex. 143 at 6,11.) This fictional imputation and retention of energy margins further, and substantially, inflates AEP Ohio's retained energy margins and, ultimately, EVA's proposed energy credit. For this reason too, Staff's flawed energy credit methodology should be rejected on rehearing.

7. EVA's estimate of gross margins that AEP Ohio will earn in the June 2012 through May 2015 period are overstated by nearly 200%, as shown by AEP witness Meehan's alternative calculation of forecast gross margins.

For the foregoing reasons, EVA's flawed inputs and approach resulted in a grossly overstated energy credit. Should the Commission agree to rehear this case, and should it continue to adhere to the view that an energy credit offset is appropriate, then the Company submits that AEP Ohio witness Meehan's supplemental testimony provides a defensible and accurate alternative calculation of gross margins. (AEP Ohio Ex. 144 at 23, *et seq.*) Pages 66-68 of AEP Ohio's initial post-hearing brief summarize the documented, transparent, and verifiable approach that Mr. Meehan took to assess the gross margins that AEP Ohio will earn from June 2012 through May 2015. The transparency of Mr. Meehan's approach was confirmed under cross examination, when counsel for IEU asked Mr. Meehan to explain each column of the hourly calculations performed for each generating unit. (Tr. XI at 2725-31.) If the Commission compares Mr. Meehan's exhibit ETM-R2 against EVA's estimate of gross margins (ESM-1), the Commission will see that EVA's estimate is nearly 200% higher than Mr. Meehan's more objective and accurate estimate of realizable margins.

8. At a minimum, the Commission should conduct an evidentiary hearing on rehearing to evaluate the accuracy of EVA's energy credit compared to actual results.

In light of the foregoing fundamental errors in Staff's energy credit, the Commission should grant rehearing and hold an evidentiary hearing for the purpose of testing the validity of

EVA's energy credit methodology against actual data. R.C. 4903.10 empowers the Commission on rehearing to hold an evidentiary hearing and accept additional evidence into the record. A hearing should be conducted in order for the Commission to evaluate the extent to which EVA's methodology grossly overstates the Company's energy margin. Newly available information confirms the inaccuracy of EVA's forecasted energy credit compared to actual results, and the Company should be granted the opportunity to present that evidence at a hearing for the Commission's consideration on rehearing. In support of this request, the Company makes the following proffer: AEP Ohio's actual energy margins for the month of June 2012 were $11,249,211. EVA's forecasted energy margins for the same month were $36,128,311 – more than <u>three times</u> higher than the Company's actual margins. For the month of June 2012 alone, EVA's methodology results in an energy credit that is overstated by $91.52/MW-day. Provisional data for July confirms a similar degree of error in EVA's projections. The Commission should grant rehearing and hold an evidentiary hearing to accept additional factual data to date regarding, and to address, this gross overstatement and inaccuracy.

C. The Commission's adoption of an energy credit that incorporates actual costs from the 2010 test period and then imputes revenues that have no basis in actual costs creates a state compensation mechanism that is unconstitutionally confiscatory and that results in an unconstitutional taking of property without just compensation.

The Commission has acknowledged that "traditional constitutional law questions are beyond [its] authority to determine." *In the Matter of the Application of Columbia Gas of Ohio, Inc., for Approval of Tariffs to Recover, Through an Automatic Adjustment Clause, Costs Associated with the Establishment of an Infrastructure Replacement Program and for Approval of Certain Accounting Treatment*, Case No. 07-478-GA-UNC, Opinion and Order at 14 (April 9, 2008). Even so, out of an abundance of caution, the Company is further including in its

Application for Rehearing such arguments as might be made to a reviewing court, in the event that the Commission denies the Company's Application for Rehearing. R.C. 4903.10 ("No party shall in any court urge or rely on any ground for reversal, vacation, or modification not so set forth in the application."). Notably, the Commission has considered the merits of constitutional claims on rehearing before, as it did in the *Columbia Gas* matter cited above (rejecting an intervenor's impairment-of-contracts claim). Of course, the Commission should adjudicate cases in such a way as to avoid constitutional infirmities. In any case, because AEP Ohio may need to seek judicial review of the Commission's July 2 Opinion and Order for constitutional defects, in the event that inadequate relief is obtained from the Commission on rehearing, the Company is ensuring that it preserves here its claims that the Commission's Opinion and Order violates the Company's constitutional rights in distinct respects.

First, the Opinion and Order violates the Company's rights under the Due Process Clause of the United States Constitution because it is confiscatory, unjust, and unreasonable under the "end result" standard articulated by the United States Supreme Court in *Fed. Power Comm. v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) and its progeny. Second, the Opinion and Order results in an unconstitutional regulatory taking of the Company's property without just compensation, under the "partial taking" standard set forth in *Penn Central Transp. Co. v. New York City*, 438 U.S. 104 (1978) and its progeny. These constitutional theories supporting modification of the Commission's Order are set forth separately in greater detail below. If the Commission agrees to rehear this case and modify its Order as the Company requests herein, then these pressing constitutional issues may be avoided.

1. **The Commission's Order is confiscatory, unjust, and unreasonable under the "end result" standard of *Hope Natural Gas*.**

The Due Process Clause of the United States Constitution prevents states from making or enforcing any law which would deprive a person of property without due process of the law. According to the United States Supreme Court, when regulatory price controls prevent a utility from realizing a reasonable rate of return, those price controls are confiscatory and, therefore, violate the Due Process Clause. *Fed. Power Comm. v. Natural Gas Pipeline Co.* 315 U.S. 575, 585 (1942) ("by long-standing usage in the field of rate regulation, the 'lowest reasonable rate' is one which is not confiscatory in the constitutional sense."); *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm. of West Virginia*, 262 U.S. 679 (1923) (reversing an administrative order prescribing utility rates because the rate calculation undervalued the plaintiff utility's capital investments); *Covington & Lexington Turnpike R.R. Co. v. Sandford*, 164 U.S. 578, 597 (1896) (holding that a prescribed rate is confiscatory if it "practically deprives the owner of property without due process of law."). *See also Fed. Power Comm. v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) (establishing an "end-result" standard for reviewing the constitutionality of regulated utility rates). Further, as discussed separately below, the July 2 Opinion and Order results in an unconstitutional partial taking due to the financial impact on AEP Ohio's generation function (later to become the AEP Genco) that is providing the capacity to support retail shopping.

In *Hope Natural Gas*, the U.S. Supreme Court held that a prescribed utility rate is too low, and thus violates due process, unless the "end result" of the rate on a utility is "just and reasonable." 320 U.S. at 603. The Court provided further guidance on this point:

> From the investor or company point of view it is important there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and

> dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

Id. See also Bluefield Water Works, 262 U.S. at 692-93 ("a public utility is entitled to such rates and will permit it to earn a return . . . equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties."). Courts have confirmed that the *Hope Natural Gas* standard means more than merely preventing a utility from going bankrupt. "*Hope Natural Gas* talks not of an interest in avoiding bankruptcy, but an interest in maintaining access to capital markets, the ability to pay dividends, and general financial integrity. While companies about to go bankrupt would certainly see such interests threatened, companies less imminently imperiled will sometimes be able to make that claim as well." *Jersey Cent. Power & Light Co. v. Federal Energy Regulatory Comm.*, 810 F.2d 1168, 1180 (D.C. Cir. 1987) (noting that "where, as here, the Commission has reached its determination by flatly refusing to consider a factor to which it is undeniably required to give some weight, its decision cannot stand.")

The Ohio Supreme Court is familiar with the *Hope Natural Gas* standard, having applied the test in multiple appeals from Commission orders. In *Dayton Power & Light Co. v. Pub. Util. Comm.*, 4 Ohio St.3d 91, 447 N.E.2d 733 (1983), the utility filed an application for a rate increase. The Commission denied the utility's requests to amortize its investment in a cancelled power plant. In its appeal to the Ohio Supreme Court, the utility contended that the exclusion of expenditures associated with the cancellation of the Killen Generation Station amounted to the confiscation of property under the Fifth and Fourteenth amendments. The Supreme Court noted that the confiscation clause of the Fifth Amendment applies to the states through the Due Process

Clause of the Fourteenth Amendment. *Dayton Power & Light*, 4 Ohio St.3d at 100, n.9. The Court ultimately concluded that there was "little evidentiary support" for DP&L's contention that exclusion of the costs associated with the cancellation of Killen Unit 1 guaranteed that DP&L would be unable to earn a "fair and reasonable rate of return," rejecting the utility's invocation of the confiscation clause. *Id.* at 104-05. The Supreme Court concluded that "the constitutional cases make it clear that a successful challenge must demonstrate that the rate order when reviewed in its entirety falls outside the 'broad zone of reasonableness,' and the 'heavy burden' of establishing unreasonableness must be borne by the challenger. *Id.* at 105 (internal citations omitted.) Notably, in support of its conclusion, the Supreme Court examined the record and found that the utility "*presented no witnesses relative to the subject and did not address the matter on brief*." *Id.* at 104-05 (emphasis added.) Thus, in the *DP&L* case, the utility attempted to prevail on the constitutional claim without any evidentiary support in the record.

A decade later, in an appeal by the Ohio Edison Company, the Ohio Supreme Court again concluded that the Commission's order did not result in confiscation of the utility's property in violation of the Fifth and Fourteenth Amendments. *Ohio Edison Co. v. Pub. Util. Comm.*, 63 Ohio St.3d 555, 589 N.E.2d 1292 (1992). Ohio Edison claimed that the "end result" of the Commission's order was to set rates so low as to prevent the company from maintaining its financial integrity, based upon its witness's testimony that the rate relief requested in the company's application ($216 million) was necessary to maintain its debt rating and dividend level. Applying the *Hope Natural Gas* line of precedent, the Supreme Court noted that "a balancing of investor and consumer interests" is required to avoid confiscation. With respect to that balance, the Court noted that:

> The Commission cannot confine its inquiries either to the computation of costs of service or to conjectures about the

> prospective responses of the capital market; it is instead obliged at each step of the regulatory process to assess the requirements of the broad public interests entrusted to its protection *** [.] Accordingly, the 'end result' of the Commission's orders must be measured as much by the success with which they protect those interests as by the effectiveness with which they "maintain *** credit and *** attract capital."

Id. at 563, *quoting Permian Basin Area Rate Cases*, 390 U.S. 747, 791, 88 S.Ct. 1344, 20 L.Ed.2d 312 (1968). Ohio Edison premised its claim of confiscation upon four allegedly erroneous determinations by the Commission: (1) the allocation of deferred costs; (2) the exclusion of certain plant that was classified as CWIP when the company filed its application, but was later transferred to plant in service; (3) the taking of judicial notice of the posthearing price at which the company's stock was trading; and (4) revisions to its traditional discounted cash flow model. *Id.* at 564. The Supreme Court concluded that, because it upheld the Commission's actions with respect to each of these individual determinations, the utility failed the first prong of the *DP&L/ Hope Natural Gas* standard and thus could not prevail in its constitutional claims. *Id.* The Supreme Court decided that "the record shows that the commission appropriately followed the legislatively mandated ratemaking formula, through which it balanced investor and consumer interests, and thereby set just and reasonable rates." *Id.* at 565.

The case at bar is easily distinguishable from the *DP&L* and *Ohio Edison* cases, where the Supreme Court rejected the utilities' confiscation claims. Although the utility in the *DP&L* case "presented no witnesses" relative to the confiscation issue, the record here is replete with testimony outlining the unreasonable and confiscatory results of the Commission's decision to adopt an energy credit that will assuredly result in a failure to compensate the Company for the embedded costs of capacity.[6] And although the utility in the *DP&L* case "did not address the matter on brief," the Company here addressed the confiscatory nature of the Commission's energy credit and the potential capacity cost outcomes at length on brief.[7] And although the utility in the *Ohio Edison* case failed to prove the unreasonableness of the Commission's determinations, the Company here is asserting (and will prove) fundamental errors far different than those at issue in that case. As the arguments above related to the Commission's energy credit demonstrate, the Company has surely met its burden to prove the unreasonableness of the Commission's determination to adopt Staff's flawed energy credit, and the confiscatory effect

[6] AEP Ohio witness Allen, for example, demonstrated that a decision which forced the Company to provide RPM-priced capacity to CRES providers would cause AEP Ohio to suffer significant financial harm. (Tr. III at 677; AEP Ohio Ex. 104 at 3-5, Ex. WAA-1; AEP Ohio Ex. 142 at 21-22, Ex. WAA-R8.) Indeed, Mr. Allen testified that financial harm to the Company is implicit in any requirement that it provide the use of its assets at a rate below its costs. (Tr. III at 697-98.) Even some intervenor witnesses testified that rates should not be confiscatory, such as RESA witness Ringenbach, who agreed that confiscation would occur if AEP Ohio incurred costs that are not being reimbursed. (Tr. IV at 802. *See also* Tr. VI at 1271-72 (witness Kollen conceding that a 7% ROE is either confiscatory or bordering on confiscatory).) The Commission itself, in its July 2 Opinion Order, agreed that "it is necessary and appropriate to establish a cost-based state compensation mechanism for AEP Ohio. *** The Commission's obligation under traditional rate regulation is to ensure that the jurisdictional utilities receive reasonable compensation for the services that they render. We conclude that the state compensation mechanism should be based on the Company's costs." July 2 Opinion and Order at 22. The Commission further agreed that "RPM-based capacity pricing would be insufficient to yield reasonable compensation for AEP-Ohio's provision of capacity to CRES providers in fulfillment of its FRR capacity obligations." (*Id.* at 23.)

[7] (*See, e.g.*, AEP Ohio Initial Br. at 4 ("At a minimum, if the energy credit is to capture the OSS margins attributed to 'freed up' energy associated with the capacity being used by a CRES provider, it should not also confiscate AEP Ohio's pre-existing traditional OSS margins that are unaffected by the sale of capacity to CRES providers."); *id.* at 5 ("One particularly egregious error was that EVA imputed a fictional market-based margin attributable to 100% of the non-shopping load and incorporated that into the energy credit to offset the charge for shopping load, which not only creates an unreasonable and unlawful subsidy but also confiscates margin that is authorized for AEP to retain under SSO rates."); *id.* at 21 (discussing the confiscatory result of ordering AEP Ohio to charge CRES providers on the RPM-based price for capacity.); *id.* at 27-28 (discussing the financial harm that would result if RPM pricing is retained in full or in part.). *See also* AEP Ohio Reply Br. at 8 (noting that RPM-based rates would undermine AEP Ohio's ability to attract capital and ensure the availability to customers of adequate, reliable, safe, efficient, nondiscriminatory, and reasonably priced retail electric service).)

that those determinations had on the non-compensatory capacity charge established in the Order. *Accord, KN Energy, Inc. v. City of Broken Bow et al.*, 244 Neb. 113, 505 N.W.2d 102 (1993) (Nebraska Supreme Court holding that rates set by municipalities were confiscatory and deprived supplier of property without due process of law when municipalities adopted rates based on erroneous assumptions of product revenue and transportation revenue, and the combined effect of the erroneous assumptions was to "decrease the return on KN's equity to a level below that which investors could earn from investments in other similar businesses"); *Potomac Elec. Power Co. v. Pub. Serv. Comm.*, 380 A.2d 126 (D.C. Cir. 1977) (holding that rate order was unjust and unreasonable since it deprived utility of opportunity to earn a fair rate of return, based on improper disregard by Commission of relevant data and other methodological errors.) In *Potomac Electric*, the D.C. Circuit concluded that "by arbitrarily disregarding actual, historical, and uncontroverted data submitted as evidence by Pepco during the extended course of the hearing, the Commission all but guaranteed that the company would not be able to approach earning the rate of return it authorized." *Id.* at 133. The *Potomac Electric* court ordered the Commission, on remand, to calculate modified rates based on updated data. *Id.* at 147-148. The Company is confident that, unless rehearing is granted and the Commission addresses the serious flaws in Staff's energy credit, the Supreme Court (or another forum with appropriate jurisdiction over the Company's constitutional claims) will agree that the Commission has unlawfully confiscated AEP Ohio's property in violation of the Fifth and Fourteenth Amendments.

2. The Commission's Order results in an unconstitutional partial taking of AEP Ohio's property without just compensation under the *Penn Central* standard.

The Fifth Amendment to the U.S. Constitution provides, in part, "nor shall private property be taken for public use, without just compensation." The U.S. Supreme Court has held that the Fifth Amendment's takings prohibition also applies to state governments through the Fourteenth Amendment. *Chicago B. & Q. R. v. Chicago*, 166 U.S. 226 (1897). Although the Takings Clause is traditionally implicated in cases involving the actual appropriation of physical property, the U.S. Supreme Court has recognized that government *regulation* is also a taking when the regulation "goes too far." *See Pennsylvania Coal v. Mahon*, 260 U.S. 393, 415 (1922) (holding that a statute restricting the exercise of coal mining rights was a taking because it had "nearly the same effect for constitutional purposes as appropriating or destroying" the property right at issue).

In order to succeed on a claim under the Takings Clause, a party must establish first that it possesses a constitutionally protected property interest. *Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1000-01 (1984). This is easily done here, because the United States Supreme Court has previously concluded that a utility provider's revenue constitutes a protected property interest. *See Duquesne Light Co. v. Barasch*, 488 U.S. 299, 308 (1989) (holding that if utility rates do not "afford sufficient compensation, then state has taken the use of utility property without paying just compensation" in violation of the Takings Clause). Where a regulation deprives property of less than 100 percent of its economically viable use, a court must consider: (1) the economic impact of the regulation on the claimant, (2) the extent to which the regulation has interfered with distinct investment-backed expectations, and (3) the character of the governmental action. *Penn Central Transp. Co. v. New York City*, 438 U.S. 104, 124 (1978).

The Ohio Supreme Court has discussed the *Penn Central* test as it relates to claims of partial regulatory takings. *E.g., Karches v. City of Cincinnati*, 38 Ohio St.3d 12, 526 N.E.2d 1350 (1988) (citing *Penn Central* in opinion holding that municipal zoning ordinance changing zoning classification from industrial to riverfront constituted impermissible taking, as applied.)

In *State ex rel. R.T.G., Inc. v. State*, 98 Ohio St.3d 1, 2002-Ohio-6716, for example, a mining company (RTG) challenged the State of Ohio's designation of 833 acres of property in which RTG owned various interests as unsuitable for mining ("USM"). The Supreme Court noted that the *Penn Central* standard applies when regulation deprives a property owner of less than 100 percent of the property's economically beneficial use. *Id.* at ¶ 35. The Court concluded that, because mineral rights are recognized under Ohio law as separate and distinct property rights, and because the state's "unsuitable for mining" designation prevented RTG from mining 1.3 million tons of coal (and rendered mining outside of the USM-designated area economically impracticable), the designation resulted in a categorical taking, even beyond the partial taking type of claim recognized in *Penn Central*. *Id.* at ¶ 57. Other courts have agreed that orders of state public utility commissions affecting utilities can amount to impermissible partial takings under the *Penn Central* test. *E.g., Pub. Serv. Co. of New Hampshire v. New Hampshire Pub. Util. Comm.*, 122 N.H. 1062, 1071-73, 454 A.2d 435 (1982) (New Hampshire Supreme Court citing *Penn Central* in support of its holding that PUC order placing conditions upon the utility's future issuance of securities resulted in an unconstitutional taking without just compensation.)

The record here is replete with evidence sufficient to satisfy *Penn Central*'s three-factor test. Multiple witnesses have testified in this proceeding to the severe economic effect that a non-compensatory capacity price will have upon the Company.[8] The Commission itself found in

[8] (*See, e.g.*, AEP Ohio Ex. 101 at 8 (Mr. Munczinski testifying that "[t]he impact on AEP Ohio's ability to be compensated for its costs has become significant due to the trend in RPM auction prices, as well as the growth in shopping by AEP Ohio customers whose CRES providers take advantage of the capacity supplied by AEP Ohio as opposed to supplying their own capacity."); *id.* at 9 (noting that aligning a state compensation mechanism with the PJM RPM price would undermine the Company's ability to provide customers with reliable and adequate service.); *id.* at 16 (noting that AEP Ohio "is not receiving adequate compensation for performing its FRR capacity obligations, and the gap between its costs and the compensation for those costs is increasing at an alarming rate. The failure to recover just and adequate compensation is threatening AEP Ohio's financial stability ... [.]") *See also* AEP Ohio Ex. 104 at 3 &

its Opinion and Order that RPM rates were "substantially below all estimates provided by the parties regarding AEP Ohio's cost of capacity," and went on to find that under RPM pricing AEP Ohio "may earn an unusually low return on equity … with a loss of $240 million between 2012 and 2013." July 2 Opinion and Order at 23. And in the related *ESP* proceeding, the Company demonstrated in the record and in its post-hearing briefs the very troubling consequences of the Commission's July 2 Opinion and Order, saying:

> At this point, given that AEP Ohio would only be permitted to charge RPM pricing to CRES providers under the 10-2929 decision, the impact (excluding consideration of the additional accounting deferral that may end up providing net cost recovery of up to $188/MW-day) of RPM pricing without the RSR yields **a projected 1.1% ROE total company in 2013, with a loss to the generation function.** (AEP Ohio Ex. 151 at 11.) **Further, the comparable projected ROE associated with the $188/MW-day rate adopted in the 10-2929 decision (absent an RSR) would be only 5.9% for 2013.** AEP Ohio has already addressed additional financial harm scenarios in its initial brief (at pages 43-46.) Even more disturbing, as discussed in its initial brief, is that **these projections involved negative or barely positive returns on a generation function basis.** (AEP Ohio Ex. 151 at 11-13; Tr. XVII at 4879.)

(AEP Ohio July 9, 2012 Reply Brief in Case No. 11-346-EL-SSO at 29) (emphasis added; internal footnotes omitted.) Although some intervenors took issue with these predictions of financial harm in the *ESP* case (with FES, for example, contending that AEP Ohio uses financial harm as "code for receiving less revenue than AEP Ohio would like to receive"), AEP Ohio

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Ex. WAA-1 (Mr. Allen prepared an estimate of AEP Ohio's earnings for 2012 and 2013 under the scenario that AEP Ohio was only able to charge a rate for its capacity that was equal to the RPM price, concluding that earnings would be $344M in 2012 with a ROE of 7.6% and $109M in 2013 with a ROE of 2.4%.) *See also* Tr. IV at 802 (RESA witness Ringenbach conceding that rates would be confiscatory if AEP Ohio incurred costs that were not being reimbursed). *See also* Tr. III at 677, 697 (Mr. Allen testifying at hearing that a decision which forced the Company to provide RPM-priced capacity to CRES providers would cause AEP Ohio to suffer significant financial harm, and that financial harm to the Company is implicit in any requirement that it provide the use of its assets at a rate below its costs.) *See also id.* at 701 (Mr. Allen testifying that if the Company is required to provide CRES providers with capacity at RPM, the Company's earnings would suffer a $240M decrease between 2012 and 2013).)

noted that the only evidence FES offered in support of its claim was that the Company earned reasonable returns when charging RPM prices *in the past,* when energy prices were high, RPM capacity prices were many multiples higher, and shopping levels were low. (*Id.* at 30, citing FES Initial Br. at 113-116.)

There is also compelling evidence that the Commission's failure to institute a state compensation mechanism that will compensate the Company for the true embedded costs of capacity will interfere with AEP Ohio's distinct investment-backed expectations.[9] Indeed, the Commission can take notice of the fact that, in an immediate response to its Opinion and Order, Standard & Poor's Ratings Service issued the following statement the next day, on July 3, 2012 regarding the impact on AEP Ohio's credit metrics:

> [I]n the longer term we believe this change will likely erode credit quality. We would consider deferrals of changes in capacity prices to be unsupportive of credit quality because cash flow would decline, and could result in financial measures inconsistent with the current rating. In addition, the business risk profile of the company is pressured as it transitions to an unregulated model for generation in Ohio.

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[9] *See, e.g.,* AEP Ohio Ex. 101 at 14 (Mr. Munczinski testifying that cost-based compensation for capacity would "provide the investment community with more certainty, eliminate some regulatory risk, and ensure sustained investment within the state of Ohio. Without the Commission's support of an appropriate and reasonable cost compensation mechanism, it would be imprudent and irresponsible for AEP Ohio to invest long-term capital in an unclear, unstable cost recovery environment.") *See also id.* at 13 (Mr. Munczinski *quoting the Commission* for the proposition that "PJM's rules do not recognize the need to recover reasonable investment costs nor the timely repayment of debt – bedrock principles required for financing an industry as capital intensive as the electricity industry."); *id.* (Mr. Munczinski again quoting the Commission for the proposition that "Generator owners cannot long survive on recovery of the short run marginal cost of energy alone, but must consistently recover some of their long run marginal costs as well.") *See also* AEP Ohio Ex. 142 at 21-22 (Mr. Allen noting that the Company's ROE would be a reasonable 12.2% in 2013 if the Commission allowed the Company to recover $355.72/MW-day in capacity charges to CRES providers.)

(Standard & Poor's Research, July 3, 2012, *available at*: www.standardandpoors.com.)[10] In the ESP proceeding, AEP Ohio witness Dr. Avera predicted precisely this kind of negative reaction from the financial community, saying:

> So I think the Commission should properly be on notice that the investment community is concerned, and that means that to put money in this company investors need higher compensation. And if their concerns become more pronounced, it could, in the extreme, lead to an inability to raise funds to make the capital investment that customers need in order to keep the lights on.

(*ESP* Tr. XVII at 4725.) Another *ESP* witness for the Company, Renee Hawkins, testified in detail about three major rating agencies' reactions to the Commission's decision to revoke the Stipulation that had previously resolved the capacity charge issue, including Standard & Poor's February 27, 2012 Bulletin cautioning that "credit quality could erode for some utilities if any transition decisions *** *disallow recovery of prudently incurred costs*, or lead to extended periods of suppressed returns and weakened credit metrics." (*ESP* AEP Ohio Ex. 102 at 11-12 & Ex. RVH-5 (emphasis added).) Based on the record developed jointly in the related capacity and *ESP* cases, it is beyond any serious dispute that the Commission's Opinion and Order here, unless modified, surely interferes with AEP Ohio's distinct investment-backed expectations.

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[10] On July 13, 2012, OCC filed a motion to strike the Standard & Poor's Research attachment to the Company's post-hearing reply brief. On July 18, 2012, the Company responded to OCC's motion by noting, *inter alia*, that the Commission previously denied a motion to strike similar financial reports appended to Company witness Hawkins' pre-filed testimony. The Company further noted that the Standard & Poor's attachment was not being offered for the truth of the matters asserted (*i.e.* the opinions of the investors), but instead to reflect investor reactions on the instability in the regulatory environment in Ohio and the impact of that on credit ratings. In any event, the Commission is not strictly bound by the Rules of Evidence and has allowed the admission of hearsay when appropriate. *In Re. Ohio Power Company*, Case No. 11-346-EL-SSO, *et al.*, Entry at 13 (Dec. 14, 2011). Moreover, analysts' reports such as the Standard & Poor's Research attachment are admissible under the "market reports" exception to the hearsay rule. *See* Evid. R. 803(17); *see also Marting Realty, Inc. v. Marks*, 5th Dist. No. 12296, 1986 WL 4647, *3 (Apr. 16, 1986) ("credit reports are held to be highly reliable by the business world and should be admitted where such reliability is not challenged.")

As for the character of the Commission's Order, the Commission has adopted a state compensation mechanism that will not fairly compensate AEP Ohio for the actual embedded costs of capacity, even while agreeing that "the state compensation mechanism *should be based on the Company's costs*." July 2 Opinion and Order at 22. The Commission's Opinion and Order, if uncorrected on rehearing, will have a significant and potentially devastating economic impact on AEP Ohio. The Commission itself has recognized that AEP Ohio has committed substantial investments to fulfill its FRR obligations and meet its obligation to provide an SSO. For these reasons, and based on the partial taking doctrine set forth in *Penn Central* and other cases, the Commission's Order unconstitutionally takes the Company's property without just compensation, and the Commission should grant the Company's Application for Rehearing to address the Company's legitimate concerns and to modify its Order as state law and the Constitution require.

II. It Was Unreasonable And Unlawful For The Commission To Adopt A Cost-Based State Compensation Mechanism And Then Order AEP Ohio To Only Charge CRES Providers RPM Pricing Far Below The Cost-Based $188.88/MW-Day Rate That The Commission Determined Was Just And Reasonable.

While the Company disagrees with the $188.88/MW-day state compensation mechanism that the Commission established in reliance upon Staff/EVA's flawed and unreasonable energy credit for the reasons discussed above, the Commission correctly determined in its July 2 Opinion and Order that "it is necessary and appropriate to establish a cost-based state compensation mechanism for AEP-Ohio." July 2 Opinion and Order at 22. Specifically, the Commission held:

> We conclude that the state compensation mechanism for AEP-Ohio should be based on the Company's costs. Although Staff and intervenors contend that RPM-based capacity pricing is just and reasonable, we note that the record indicates that the RPM-based capacity pricing has decreased greatly since the December 8, 2010,

> entry was issued, and that the adjusted RPM rate currently in effect is substantially below all estimates provided by the parties regarding AEP-Ohio's cost of capacity. * * * In short, *the record reveals that RPM-based capacity pricing would be insufficient to yield sufficient reasonable compensation for AEP-Ohio's provision of capacity to CRES providers in fulfillment of its FRR capacity obligations.*
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> * * *
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> Therefore, with the intention of adopting a state compensation mechanism that achieves a *reasonable* outcome for all stakeholders, the Commission directs that the state compensation mechanism shall be based on the costs incurred by the FRR Entity for its FRR capacity obligations * * * [.]

Id. at 22-23 (emphasis added). Despite its recognition of a cost-based capacity price as the just and reasonable state compensation mechanism, the Commission nonetheless determined that "RPM-based capacity pricing will promote retail electric competition" and "direct[ed] AEP-Ohio to charge CRES providers the final zonal PJM RPM rate in effect for the rest of the RTO region for the current PJM delivery year * * * [.]" *Id.* at 23.

To account for the difference between the price it determined to be just and reasonable and the fraction of that price it authorized the Company to recover from CRES providers, the Commission stated:

> [T]he Commission will authorize AEP Ohio to modify its accounting procedures, pursuant to Section 4905.13, Revised Code, to defer incurred capacity costs not recovered from CRES provider billings during the RSP period to the extent that the total incurred capacity costs do not exceed the [$188.88/MW-day] capacity pricing that we approve below. Moreover, the Commission notes that we will establish an appropriate recovery mechanism for such deferred costs and address any additional financial considerations in [Case No.] 11-346 * * * [.]

Id.

The Commission's decision to adopt a cost-based state mechanism and then nonetheless order the Company to charge CRES providers RPM pricing was unreasonable and unlawful for the following reasons: (1) the Commission lacks authority authority to determine that a cost-based rate is just and reasonable and then order the Company to charge a non-cost-based rate; (2) the Commission's decision unreasonably failed to provide for a mechanism to recover the deferrals it created; (3) the decision enables and promotes artificial, uneconomic, and subsidized competition at the Company's expense; (4) it also unreasonably and unnecessarily extends RPM pricing to CRES providers serving customers who already shopped based on capacity priced at $255/MW-day; and (5) the Commission unreasonably and unlawfully relied upon provisions in R.C. Chapter 4928 after expressly holding that that chapter is inapplicable to AEP Ohio's capacity service.

A. If the state compensation mechanism is cost-based and the Commission found AEP Ohio's cost of providing capacity to be $188.88/MW-day, then it is unreasonable and unlawful for the Commission to require AEP Ohio to charge anything other than $188.88/MW-day.

The Commission's decision to disregard its own determination that a $188.88/MW-day cost-based rate is the lawful rate that the Company should receive from CRES providers for the capacity it supplies them and instead order the Company to supply CRES providers with capacity for a fraction of its costs is patently unreasonable. As the Commission itself has noted, the Commission is "a creature of statute" and "may exercise only the authority conferred upon it by the General Assembly." July 2 Opinion and Order at 12, *citing Tongren v. Pub. Util Comm.*, 85 Ohio St.3d 87, 88 (1999). R.C. 4905.22 vests the Commission with the authority to allow an electric utility to collect only those charges that are "just and reasonable." It does not authorize the Commission to require a utility to collect less that a just and reasonable charge. Indeed, nowhere in the Ohio Revised Code is the Commission granted such authority. Accordingly, because the Commission lacks statutory authority to require AEP Ohio to charge less than the cost-based rate that the Commission determined to be just and reasonable, the Commission should grant rehearing and authorize the Company to charge CRES providers a rate equivalent to the Company's full embedded cost of capacity.

B. It was unreasonable and unlawful for the Commission to authorize AEP Ohio to collect only RPM pricing and require deferral of expenses up to $188.88/MW-day without simultaneously providing for recovery of the shortfall.

As discussed above, the Commission's July 2 Opinion and Order limits AEP Ohio to the collection of only a fraction of its costs of capacity and requires deferral of the Company's capacity costs above that price up to the Commission-determined $188.88/MW-day "cost of capacity." Notably absent from the Opinion and Order is a provision authorizing AEP Ohio to recover the amounts deferred. Rather, the Commission states that it will establish "an appropriate recovery *mechanism*" (*see* July 2 Opinion and Order at 23 (emphasis added)) in another proceeding that, as of the date of the Commission's decision in this proceeding, had already completed hearing and initial post-hearing briefing. The July 2 Opinion and Order does not, however, authorize the Company to actually recover those deferrals.

This treatment of the deferrals that the Commission itself created is inappropriate and unreasonable. This fragmented approach is inappropriate, especially because the two cases involve a host of unrelated issues and will be subject to independent rehearing and appeal processes. It was unreasonable to bifurcate a single decision into two separate proceedings being decided at different times. Without the existence of an ESP decision that authorizes recovery of the capacity cost deferrals, the decision in this case to provide a discount is unreasonable and unlawful. The Commission should grant rehearing to reverse its decision creating the below-cost discount and instead authorize the Company to collect its full cost of capacity from CRES providers.

C. **It is unreasonable and unlawful for the Commission to require AEP Ohio to supply capacity to CRES providers at a below-cost rate to promote artificial, uneconomic, and subsidized competition.**

The Commission appears to have based its decision to require the Company to collect only a fraction of its costs of capacity from CRES providers on the belief that "RPM-based capacity pricing will further the development in the competitive market" and "promote retail electric competition." July 2 Opinion and Order at 23. Unfortunately, the Company foresaw the possibility of such a decision. (*See* AEP Ohio Initial Br. at 18-19, 29-31; AEP Ohio Reply Br. at 12 ("In any case, if the Commission is to establish a cost-based rate, it should not reduce the rate simply to boost shopping statistics – especially given the financial harm to AEP Ohio associated with RPM pricing.").) Nonetheless, the Commission unreasonably and unlawfully ordered that AEP Ohio to collect only an RPM-based charge for the capacity it supplies to CRES providers.

As the Company demonstrated through witness testimony and post-hearing briefing, RPM-based capacity pricing does nothing more than promote artificial, uneconomic, and subsidized "competition," and does not foster durable, legitimate competition. AEP Ohio witness Graves explained that adopting an RPM-based charge will induce an uneconomic bypass opportunity for CRES providers at the expense of the Company's customers and the Company itself, and an RPM-based charge will not foster efficient competition. (AEP Ohio Initial Br. at 18; AEP Ohio Ex. 105 at 7.)

It is a matter of basic economics that CRES providers will increasingly enter the market the lower their price of capacity drops – there is little doubt that market entry would increase even more rapidly if the Company were ordered to charge nothing for its capacity. That increase in "competition," however, is unsustainable. It will serve only to create a market of free riders that likely could not compete if capacity were priced at a reasonable amount and will not foster the development of a robust and efficient market for competitive retail electric service in Ohio. (AEP Ohio Initial Br. at 18.) Such artificial and manufactured "competition" for "competition's" sake does not benefit customers in the long run and, in fact, is likely to harm customers (shopping and nonshopping), AEP Ohio, and the state economy. (*See* AEP Ohio Initial Br. at 18-19, 29-31.)

The Commission's July 2 Opinion and Order disregards the harms to customers, the Company, and the State as a whole that are likely to occur in favor of flooding the market with unsustainable competitive retail electric service. That decision is unreasonable and unlawful and should be reversed and modified on rehearing.

D. It was unreasonable and unlawful, as well as unnecessary, for the Commission to extend RPM pricing to customers that already switched based on a capacity price to CRES providers of $255/MW-day.

In the July 2 Opinion and Order, the Commission "direct[ed] AEP-Ohio to charge CRES providers the adjusted final zonal PJM RPM rate in effect for the rest of the RTO region for the current PJM delivery year." July 2 Opinion and Order at 23. The Commission did so, as discussed above, to "promote retail electric competition." *Id.* In addition to the other reasons discussed elsewhere in this application for rehearing, the Commission's decision was unreasonable in that it failed to account for the fact that a significant number of customers switched to competitive retail electric service when the price of capacity was $255/MW-day.

As the Company explained in its post-hearing briefs, AEP Ohio witness Allen demonstrated, and RESA witness Ringenbach confirmed, that CRES providers have made offers and customers have switched when at a capacity charge of $255/MW-day. (AEP Ohio Initial Br. at 17-18.) Thus, retail electric competition was being promoted and was occurring at that price. Those contracts were never based on RPM pricing, and they were entered into well after this proceeding commenced; thus, there is no concern that a customer or CRES provider entered into such an agreement with the expectation the capacity charge would be based on RPM. For this reason, it is unnecessary for the Commission to intervene by ordering that CRES providers pay AEP Ohio RPM rates with respect to those retail contracts that were entered into based on $255/MW-day pricing.

Through its July 2 Opinion and Order, the Commission has created a significant windfall for CRES providers serving customers who entered into retail contracts based on $255/MW-day capacity pricing – to the Company's financial detriment – and there is no requirement or guarantee that those retail customers will realize any financial benefit. Now, instead of receiving $255/MW-day for capacity supplied to the CRES provider serving a customer under such an agreement, the Company will receive a near-zero RPM-based price and a deferral, which will total less than the amount to which it was previously entitled, and which has no recovery mechanism. This result is unreasonable and unlawful. The Commission should correct this shortcoming on rehearing and except from its decision any contracts entered into for which capacity was priced at $255/MW-day.

E. It was unreasonable and unlawful for the Commission to rely critically on the policies set forth in R.C. 4928.02 and 4928.06(A) to justify reducing CRES providers' price of capacity after the Commission found that R.C. Chapter 4928 does not apply to AEP Ohio's capacity charges to CRES providers.

Addressing IEU Ohio's contention that the Commission lacks statutory authority to approve a cost-based rate for capacity available to CRES providers in the Company's service territory, the Commission stated that it is not required to determine whether the service is competitive or non-competitive under R.C. Chapter 4928 because it is not a retail service. July 2 Opinion and Order at 13. Specifically, the Commission stated:

> IEU-Ohio contends that the Commission must determine whether capacity service is a competitive or noncompetitive retail electric service pursuant to Chapter 4928, Revised Code. Section 4928.05(A)(1), Revised Code, provides that competitive retail electric service is, to a large extent, exempt from supervision and regulation by the Commission, including pursuant to the to the Commission's general supervisory authority contained in Sections 4905.04, 4905.05, and 4905.06, Revised Code. Section 4928.05(A)(2), Revised Code, provides that noncompetitive retail electric service, on the other hand, generally remains subject to supervision and regulation by the Commission. Prior to determining whether a retail electric service is competitive or noncompetitive, however, we must first confirm that it is indeed a retail electric service. Section 4928.01(A)(27), Revised Code, defines a retail electric service as "any service involved in supplying or arranging for the supply of electricity to ultimate consumers in this state, from the point of generation to the point of consumption." In this case, the electric service in question (*i.e.*, capacity service) is provided by AEP-Ohio to CRES providers, with CRES providers compensating the Company in return for its FRR capacity obligations. Such capacity service is not provided directly by AEP-Ohio to retail customers. Although the capacity service benefits shopping customers in due course, they are initially one step removed from the transaction, which is more appropriately characterized as an intrastate wholesale matter between AEP Ohio and each CRES provider operating in the Company's service territory. As AEP-Ohio notes, many of the parties, including the Company, regard the capacity compensation assessed by the Company to CRES providers as a wholesale matter. We agree that *the provision of capacity for CRES providers by AEP-Ohio, pursuant to the Company's FRR capacity obligations, is not a retail electric service as defined by Ohio law. Accordingly, we find it unnecessary to determine whether capacity service is considered a competitive or noncompetitive service under Chapter 4928, Revised Code.*

Id. (emphasis added, internal record citations omitted). The Commission thus determined that R.C. Chapter 4928 is inapplicable to AEP Ohio's capacity charges to CRES providers. *See also id.* at 22 ("Although Chapter 4928, Revised Code, provides for market-based pricing for retail electric generation service, *those provisions do not apply* because, as we noted earlier, capacity is a wholesale rather than a retail service.") (emphasis added).

The Commission went on, however, to order that the Company supply capacity to CRES providers at RPM-based prices because RPM-based capacity pricing because it would "advanc[e] the state policy objectives of Section 4928.02, Revised Code, which the Commission is required to effectuate pursuant to Section 4928.06(A), Revised Code." *Id.* at 23. That rationale plainly contradicts the Commission's own determination that R.C. Chapter 4928 does not apply to AEP Ohio's capacity charges.

The Commission is not authorized to pick and choose to apply only some provisions of Chapter 4928 to the Company's capacity service. Either the service is a retail electric service, and therefore subject to R.C. Chapter 4928, or it is not. The Commission went to great lengths to explain why AEP Ohio's capacity service is a wholesale and not a retail electric service. It may not make that determination and then rely on inapplicable statutory provisions to justify its order to reduce CRES providers' cost of capacity to a fractional RPM-based rate. Accordingly, the Commission's decision to reduce CRES providers' cost of what the Commission has concluded is wholesale capacity below the cost-based charge to which the Company is entitled was unreasonable, without statutory basis, and unlawful. It should be reversed on rehearing and the Company should be authorized to collect a capacity charge from CRES providers equivalent to its embedded costs.

III. It Was Unreasonable And Unlawful For The Commission To Fail To Address The Merits Of AEP Ohio's January 7, 2011 Application For Rehearing, Which The Commission Granted On February 2, 2011 For The Purpose Of Further Considering It, In The July 2 Opinion and Order.

The Commission initiated this proceeding by entry on December 8, 2010, in response to AEP Ohio's November 2010 application to the Federal Energy Regulatory Commission ("FERC") proposing to change the basis for compensation for its capacity costs under Section D.8 of Schedule 8.1 of the Reliability Assurance Agreement ("RAA") from an RPM-based rate to a cost-based rate. *See* December 8, 2010 Entry at 1. The Commission sought comments from interested parties on a number of issues that the Commission believed would assist it to "determine the impact of the proposed change to AEP-Ohio's capacity charges." *Id.* at 2. The Commission also adopted RPM-based price for capacity as the state compensation mechanism during the pendency of its review. *Id.*

AEP Ohio filed an application for rehearing of the Commission's December 8, 2010 Entry ("December 8 Entry") on January 7, 2011, arguing that the entry was unreasonable and unlawful in several respects. *See* January 7, 2011 Appl. for Rehearing. The Company argued, *inter alia*, that the Commission lacks jurisdiction under both Federal and Ohio law to issue an order affecting wholesale rates regulated by the FERC and that portions of the Commission's December 8 Entry conflict with and are preempted by federal law. *Id.* On February 2, 2011, the Commission granted the Company's application for rehearing for "further consideration of the matters specified" therein. February 2, 2011 Entry on Rehearing at 2.

The Commission has not issued a decision on the merits regarding the arguments raised in the Company's January 7, 2011 application for rehearing. The July 2 Opinion and Order, while apparently intended to address all outstanding issues in this proceeding, does not mention the January 7, 2011 application for rehearing and does not specifically address any of the arguments raised therein. The Commission thus has erred in failing to either grant or deny the January 7, 2011 application for rehearing. This error should be corrected on rehearing of the July 2 Opinion and Order.

CONCLUSION

For the foregoing reasons, the Commission should grant rehearing and should reverse and modify its July 2 Opinion and Order.

Respectfully submitted,

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On behalf of Ohio Power Company

CERTIFICATE OF SERVICE

I hereby certify that a copy of the *Application for Rehearing of Ohio Power Company* was served by electronic mail upon counsel for all other parties of record in this case on this 20th day of July, 2012.

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I certify that the foregoing *Merit Brief and Appendix of Appellee/Cross-Appellant Ohio Power Company* was served by First-Class U.S. Mail or hand delivery upon counsel for parties to this proceeding, identified below, this 23rd day of September, 2013.

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