ORIGINAL

IN THE SUPREME COURT OF OHIO

12-2098

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

THIRD MERIT BRIEF OF APPELLANT FIRSTENERGY SOLUTIONS CORP.

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I. INTRODUCTION

It is often stated that the Public Utilities Commission of Ohio ("PUCO") is a creature of statute. In this case, the PUCO's authority springs not only from the delegation of authority by the General Assembly but also from the delegation of authority from the Federal Energy Regulatory Commission ("FERC"). The former is determined by the nature of the service: *i.e.*, is the service (or the asset or group of assets used to provide that service) competitive? The latter is determined by the nature and purpose of the market that FERC approved as part of the Reliability Assurance Agreement ("RAA") to ensure reliability within the PJM Interconnection, LLC ("PJM") region. Under either delegation of authority, the PUCO erred in establishing a cost-based state compensation mechanism based on Ohio Power Company's ("AEP Ohio") purported embedded costs.

In responding to FES' Proposition of Law No. 1, AEP Ohio and the PUCO largely ignore the RAA and, more importantly, the capacity market the RAA constructed to ensure reliability. Tellingly, neither AEP Ohio nor the PUCO attempt to dispute the governing RAA principle set out in FirstEnergy Solutions Corp.'s ("FES") Brief: RAA compensation is designed to ensure reliability through competitive markets and the use of avoidable costs, not to compensate AEP Ohio for its full embedded costs. *See* Merit Brief of FirstEnergy Solutions Corp. ("FES Brief"), pp. 19-26. Market prices are not explicitly cost-based and do not guarantee or provide any allowance for the opportunity to earn any (much less a "fair") rate of return. Suppliers offer their goods at prices that are no less than their avoidable costs. If market prices fall below that level, a supplier's rational economic decision would be not to offer its services. In the case of generation services, a supplier would retire or mothball the generation unit. If a supplier can achieve market prices in excess of its avoidable costs, then the margin earned reimburses the supplier for other

(embedded) costs. Notably, the FERC has found that the capacity prices that result from PJM's Reliability Pricing Model ("RPM") and that are based only on avoidable costs (as opposed to the full embedded costs that underlie the PUCO's state compensation mechanism) are "just and reasonable" and provide important incentives to reduce prices for customers while ensuring reliability. *In re PJM Interconnection, LLC,* 121 FERC ¶ 61,173 at ¶¶ 3, 31-32 (2007).

By creating a narrow exception for Fixed Resource Requirement ("FRR") entities to "self-supply" capacity, PJM could not have created a mechanism that would allow excessive above-market pricing. If that were true, then every supplier would have opted for such favored status; the competitive capacity market that the RAA sought to create would have never happened. Further, as interpreted by AEP Ohio and the PUCO, a state compensation mechanism could compensate a utility for its generation assets at a level far in excess of the amount necessary to ensure reliability in the PJM region.

The state compensation mechanism provided for in the RAA does not give the PUCO a carte blanche. The state compensation mechanism is available only in states where there is retail competition. All parties to the RAA, including AEP Ohio, agreed to implement the RAA "in a manner consistent with the development of a robust competitive marketplace." (Supplement of FirstEnergy Solutions Corp. ("Supp.") 145, 168.) Thus, state compensation mechanisms must not be antithetical to the development of competitive retail markets.

Ohio law is no different. It is undisputed that capacity is a generation-related service. Under R.C. Chapter 4928, such services are competitive. Moreover, Chapter 4928 also directs that all generation assets be exposed to the competitive market. R.C. § 4928.38. Customers are entitled to receive generation service from any supplier in the market. R.C. § 4928.03. The PUCO is required to ensure that generation service is provided within a competitive market that

is free from any abuse of market power or any undue advantage or preference provided by the incumbent electric utility. R.C. §§ 4928.02, 4928.17. Electric utilities must legally separate their generation assets from their distribution assets. R.C. § 4928.17. There are no exceptions for generation service that a utility is providing using legacy generation assets that it failed to separate as required by law. There are no exceptions for a utility that acts to acquire all of the rights to provide a generation-related service in its territory and blocks other capacity suppliers for providing that service to its distribution customers. All electric generation in Ohio – whether still provided by an electric utility or provided by a competitive retail electric service ("CRES") provider – is subject to the competitive market. The PUCO's award of above-market compensation to AEP Ohio for its generation assets is both unreasonable and unlawful.

AEP Ohio and the PUCO contend that AEP Ohio is unique and therefore is entitled to preferred, above-market revenues for capacity. This is wrong for at least two reasons. First, it is the service – not who provides it – that determines how it should be priced or regulated. Capacity is a competitive service, and the generation assets used by AEP Ohio to provide that service are fully on their own in the competitive market. Capacity provided by AEP Ohio is no different than capacity provided by any other generation supplier. Second, AEP Ohio's "uniqueness" is solely a function of choices that AEP Ohio made: to declare itself an FRR entity under the RAA and thus obligate itself to supply all of the capacity in its service territory. Having made that choice and having lived with market-based pricing (apparently in excess of its costs) for its capacity service, AEP Ohio has little claim to complain about such pricing when capacity market prices soften.

The competitive market created in Ohio requires a level playing field for all participants providing electric generation service. The playing field is no longer level when one capacity

supplier (AEP Ohio) receives guaranteed revenue well above the market price received by all other suppliers. All other capacity suppliers are subject to the important economic incentives of competition that lead to greater efficiencies and lower prices. But the PUCO's state compensation mechanism for AEP Ohio would allow AEP Ohio to enjoy the protection of a guaranteed ability to recover its full costs in providing capacity. When both the federal system and the state system are based on competition and market-based pricing, the PUCO has no authority to revert to noncompetitive, traditional rate regulation for AEP Ohio's capacity and uniquely remove AEP Ohio from the competitive market.

The PUCO's Opinion and Order ("Order") approving a price for capacity above PJM's RPM, market-based price is unlawful and unreasonable from any angle. It conflicts with the RAA's twin objectives of ensuring reliability and promoting robust competitive markets. And it conflicts with this state's transition of generation services and assets to competitive markets. Even if AEP Ohio is somehow uniquely entitled to be separated from the competitive market and entitled to traditional rate regulation for its capacity, then the PUCO must follow the ratemaking formula mandated by Chapter 4909, which it failed to do here. The PUCO's Order should be reversed.

II. FES' PROPOSITIONS OF LAW SHOULD BE ADOPTED BECAUSE APPELLEES' ARGUMENTS ARE UNSUPPORTED BY LAW OR THE RECORD EVIDENCE.

A. FES PROPOSITION OF LAW NO. 1: The PUCO May Not Establish A Rate For An FRR Entity's Capacity Obligation By Reference To Full Embedded Costs Because Such A Rate Conflicts With Applicable FERC Tariffs.

The FERC-approved RAA establishes the framework through which capacity is priced in PJM. PJM's capacity market, as established by the RAA, includes the possibility of a "state

compensation mechanism" for capacity in states implementing competitive retail choice. (Supp. 12-13, 19, 163.) PJM's RPM process ensures that sufficient capacity resources are available to provide reliable service to loads with the PJM region using an advanced auction process in which bids/prices are based no higher than a supplier's avoidable costs. (Supp. 9-10, 13-14, 145.) The PUCO's state compensation mechanism for AEP Ohio's capacity is unlawful and unreasonable because it conflicts with the sound economic policy on which this framework is founded. It over-compensates AEP Ohio for reliability. By guaranteeing AEP Ohio the ability to recover its full embedded costs (which are much more expansive than avoidable costs), AEP Ohio will be immune to the incentives of capacity pricing based on avoidable costs and the RAA's goal of ensuring reliable service in a manner consistent with robust competitive markets will be thwarted.

Therefore, the Court should reverse the PUCO's Order pursuant to FES' Proposition of Law No. 1 and, for the same reasons, should reject AEP Ohio's Proposition of Law No. I. (*See* Merit Brief and Appendix of Appellee/Cross-Appellant Ohio Power Company ("AEP Ohio Br."), pp. 8-13.) The PUCO's Proposition of Law No. I, to the extent the PUCO argues that its state compensation mechanism is supported by the FERC or PJM's RAA, also should be rejected. (*See* Second Merit Brief Submitted on Behalf of the Public Utilities Commission of Ohio ("PUCO Br."), pp. 18-23.)

1. **The RAA and the economic model it establishes require a market-based state compensation mechanism. To do otherwise would eviscerate PJM's well-crafted system for providing reliable service within the PJM region through market-based capacity pricing.**

The state compensation mechanism for AEP Ohio established in this case, which allows for recovery of full embedded costs, is at odds with PJM's RAA. Attempting to defend this

inconsistency, AEP Ohio and the PUCO respond that the RAA does not expressly limit the terms of a state compensation mechanism. (*See* PUCO Br., p. 20; AEP Ohio Br., pp. 11-12.) This ignores the structure and purpose of the RAA. Neither AEP Ohio nor the PUCO address the reliability and competitive marketplace objectives expressly set out in the RAA:

> This Agreement is intended to ensure that adequate Capacity Resources, including planned and Existing Generation Capacity Resources, planned and existing Demand Resources, Energy Efficiency Resources, and ILR will be planned and made available to provide reliable service to loads within the PJM Region, to assist other Parties during Emergencies and to coordinate planning of such resources consistent with the Reliability Principles and Standards. Further, it is the intention and objective of the Parties to implement this Agreement in a manner consistent with the development of a robust competitive marketplace.

(Supp. 145.) Neither AEP Ohio nor the PUCO explain how a state compensation mechanism using full embedded costs, instead of avoidable costs, could ever be consistent with these RAA objectives. AEP Ohio's and the PUCO's attempt to separate the FRR obligation from the RAA itself must fail given that the RAA created the FRR obligation solely as an alternative means to ensure reliable service and, thus, must be based on avoidable costs. (Supp. 30-31, 158.) AEP Ohio's argument that the RAA would have said "avoidable costs" if the RAA was intended to limit the FERC's secondary authority to approve a cost-based price also should be rejected for similar reasons. (*See* AEP Ohio Br., pp. 11-12.) A cost-based price must be designed to achieve the RAA's purposes, but a full embedded cost rate conflicts with the RAA's purposes. *See PPL EnergyPlus, LLC v. Hanna*, 2013 WL 5603896 (D.N.J. Oct. 11, 2013) (state imposition of cost-based capacity price unlawfully conflicts with RPM's purpose by creating "an obstacle to the [FERC's] preferred method for the wholesale sale of electricity in interstate commerce"). Such a rate only over-compensates AEP Ohio for its capacity.

PJM designed the RAA and its RPM to approximate the market value of available capacity. (Supp. 23.) The market price incentivizes the entry of new, cost-efficient resources and the exit of inefficient resources over the investment horizon, while promoting lower prices. (*Id.*) The Brattle Group, of which AEP Ohio's expert witness Frank Graves is a principal, was retained by PJM to evaluate RPM and issued a report supporting PJM's RPM:

> Our primary finding is that RPM is performing well. Despite concerns by some stakeholders, **RPM has been successful in attracting and retaining cost-effective capacity sufficient to meet resource adequacy requirements. . . . RPM has reduced costs by fostering competition among all types of new and existing capacity, including demand-side resources. It has also facilitated decisions regarding the economic tradeoffs between investment in environmental retrofits on aging coal plants or their retirement.**

(FES Ex. 101, Direct Testimony of Robert B. Stoddard ("Stoddard Testimony"), Ex. RBS-6, p. I (emphasis added).) The FERC has supported the RPM, market-based approach, based on avoidable costs, to capacity pricing:

> **Such competitive market mechanisms provide important economic advantages to electricity customers in comparison with cost of service regulation.** For example, a competitive market with a single, market-clearing price **creates incentives for sellers to minimize their costs**, because cost-reductions increase a seller's profits. And when many sellers work to minimize their costs, **competition among them keeps prices as low as possible.**

In re PJM Interconnection, LLC, 121 FERC ¶ 61,173 at ¶ 32 (*quoting* 117 FERC ¶ 61,331, at ¶ 141) (emphasis added).

A key facet of the RPM process is that all capacity suppliers with generation not otherwise committed must offer their capacity into the RPM capacity auctions. (Supp. 13.) Further, those suppliers participating in the offers are subject to a maximum offer bid that is largely based on the supplier's avoided cost. (Supp. 14.) If a supplier's bid is in excess of the

price cleared in the auction, the supplier's incentive is to restore or mothball that generation. (Supp. 15-16.) A supplier whose bid clears the auction can recover not only its avoided costs, but also some of its embedded costs. (Supp. 14-16.)

If, as the PUCO and AEP Ohio assert, a state could implement a compensation mechanism for capacity that is based on full embedded costs, then competition and its significant benefits would be eliminated. Capacity suppliers would instead be incentivized to divert capacity to that state to obtain the higher capacity payments and get guaranteed cost recovery that would remove the beneficial pressure to reduce costs for customers. (Supp. 24.) FES witness Stoddard – the only drafter of the RAA to testify in this proceeding – explained the risk of providing such a significant exception to capacity pricing:

> [M]y view of it as we wrote this [i.e., the RAA], we were talking just about avoidable costs. We were trying to set up a market structure that didn't turn the FRR into some way that a regular entity could get a really big number, whereas if they were going to be in the RPM, they would do poorly.
>
> What we would have done then is create an exception that swallowed the rule. Everyone that could have taken that option would have chosen to get some high value. The point of this market is to be comprehensive. The point of the FRR was to allow a very limited carve-out for firms that had regulatory reasons and state reasons to seek a different structure.

(Tr. Vol. VIII, pp. 1647-48.) Mr. Stoddard also noted that the RAA never uses the term "embedded cost"; the only costs discussed or referred to are avoidable costs. (Supp. 18.) This made sense given that avoidable costs are the only costs that come into play when a supplier participates in a competitive market. No supplier in a fully competitive market would consider recovery of its embedded costs in setting prices or participating in a market.

That AEP Ohio is an FRR entity not participating in the RPM auctions does not call for a different consideration of costs in setting capacity prices. This is especially so when such prices are set via a state compensation mechanism. The RAA allows for state compensation mechanisms only in states in which there is retail competition. (Supp. 13, 163.) Given that states having retail competition are reliant on competitive markets to drive prices to marginal cost, a cost-based state compensation mechanism can be based only on avoidable costs. Embedded costs are irrelevant. Indeed, AEP Ohio's suggestion that the idea that the state compensation mechanism should be consistent with PJM's RAA "defies basic economics" (AEP Ohio Br., pp. 12-13) is laughable. The opposite is true: it is the PUCO and AEP Ohio that ignore "basic economics." It is "basic economics" that a competitive market does not guarantee the full recovery of any costs. If a supplier is inefficient and cannot price its product to capture sales and recover its "to go" or avoidable costs, then that supplier will become more efficient or exit the market.

AEP Ohio claims that it should be entitled to collect its full embedded costs (when no other generator in PJM is so entitled) because the RPM auction prices have not attracted investment in generation. (*See* AEP Ohio Br., p. 5.) This illustrates AEP Ohio's misunderstanding of the economics of the market-based RPM system. AEP Ohio's claim is also unsupported. The RPM auction price is designed to ensure that sufficient capacity resources are available to provide reliable service and to promote lower prices. (*See* Supp. 145; *In re PJM Interconnection, LLC,* 121 FERC ¶ 61,173 at ¶ 3 (2007) (quoting *In re PJM Interconnection, LLC*, 119 FERC ¶ 61,318 at ¶ 191).) It seeks to incentivize the entry of new, cost-efficient resources and the exit of inefficient resources over a long-term investment horizon. (Supp. 23, 50-51.) The goal is not to simply increase investment and build new generation not needed to

ensure reliable service. Such uneconomic investments only lead to higher prices for customers. Indeed, that's exactly what the PUCO-approved state compensation mechanism does here – over-compensate AEP Ohio for its capacity and over-charge retail customers. In any event, AEP Ohio's expert witness Graves admitted that the RPM market is working very well and is attracting sufficient generation capacity: PJM has excess capacity and an additional 5-9 GW is planned to come on line. (Tr. Vol. V, pp. 869-871; Stoddard Testimony, Ex. RBS-6, p. I; *see also* Supp. 52-53 (the RPM model already has incentivized more than 28,000 MW of new resources.)

PJM's RAA calls for prices that are, in part, based on avoidable costs. This produces market-based prices, and results in just and reasonable prices that ensure reliability and benefit customers. The PUCO's state compensation mechanism is based on embedded costs, produces a significantly above-market price, and does not benefit customers. Its failure to adhere to principles underlying PJM's RAA, which authorizes a state compensation mechanism in the first place, renders the PUCO's Order unlawful and unreasonable.

2. FERC has not approved the state compensation mechanism; FES' arguments are properly before this Court.

Both AEP Ohio and the PUCO assert that the FERC has "approved" or "confirmed" the entirety of the PUCO's state compensation mechanism for AEP Ohio. (*See* PUCO Br., pp. 22-23; AEP Ohio Br., pp. 9-10.) That is simply not true. The FERC only approved one portion of the state compensation mechanism: the RPM-based charge to CRES providers—a charge that FES does not challenge. (*See* Response of Appellant FirstEnergy Solutions Corp. to Amended Motion to Dismiss of Ohio Power Company ("FES' Response"), filed Jul. 24, 2013, pp. 7-10.) As FES' Response shows, AEP Ohio indeed asked the FERC to affirm the entirety of the state

compensation mechanism (including language in the proposed appendix referencing the $188.88/MW-day total state compensation mechanism price). But the appendix actually approved by the FERC states only that the wholesale rate charged to CRES providers shall be the final PJM RPM market-based price determined for each PJM delivery year:

> The Public Utilities Commission of Ohio (PUCO) in Case No. 10-2929-EL-UNC on July 2, 2012, issued an order approving a state compensation mechanism for load of alternative retail LSEs (a/k/a Competitive Retail Electric Service (CRES) providers) in Ohio Power Company's FRR Service Area for FRR capacity made available by Ohio Power Company under the RAA, effective as of August 8, 2012. For purposes of administering the state compensation mechanism, the wholesale rate shall be equal to the adjusted final zonal PJM RPM rate in effect for the rest of the RTO region for the current PJM delivery year, and with the rate changing annually on June 1, 2013, and June 1, 2014, to match the then current adjusted final zonal PJM RPM rate in the rest of the RTO region. The Final Zonal Capacity Price will be the price applicable to the unconstrained region of PJM adjusted for the RPM Scaling Factor, the Forecast Pool Requirement and Losses.

June 30, 2013 Compliance Filing (attached as Attachment 1 to FES' Response) at Att. B; 134 FERC ¶ 61,036 ("FERC Order"), at ¶ 14. The FERC concluded only that this more limited language was consistent with the RAA. FERC Order, ¶¶ 26, 30. The FERC reached no conclusions regarding the distinct, above-market component of the state compensation mechanism. That component, which is the focus of FES' appeal here, was not included in the appendix that the FERC approved. *See, generally,* FERC Order. The FERC's Order did nothing more than approve the limited appendix.

FES' challenges are properly before this Court. AEP Ohio argues that FES should be barred from arguing that the PUCO's state compensation mechanism is unlawful and unreasonable based on "claim preclusion" and the "supremacy" of the FERC tariff. (AEP Ohio Br., pp. 9-11.) Claim preclusion is inapplicable because the FERC Order approved a market-

based rate for AEP Ohio's FRR capacity committed to shopping load – this is exactly the relief that FES believes AEP Ohio should receive both at the FERC and before the PUCO. Therefore, FES has no objections to the FERC Order.

AEP Ohio also argues that FES should be precluded from its challenges here because FES did not take the "chance to tell federal regulators that the Commission's order conflicts with tariffs, like the RAA, that are within FERC's jurisdiction." (AEP Ohio Br., p. 10.) But FES did make those exact protests at the FERC to AEP Ohio's proposed appendix. FirstEnergy Service Company, on behalf of FES, filed a "Motion to Intervene, Protests, and Requests for Rejection, Maximum Suspension and Evidentiary Hearing" in response to AEP Ohio's proposed appendix. *See* FERC Order, ¶¶ 9-10. FES protested that AEP Ohio's proposed reference to $188.88/MW-day did not accurately reflect the wholesale component of the state compensation mechanism (which is limited to the RPM market price). FES also argued that any charge based on AEP Ohio's $188.88/MW-day embedded cost figure is inconsistent with the RAA. (*See* FES Response, pp. 8-10, Attachment 1, pp.1-2 (AEP Ohio admitting that "AEP agreed to revise the Ohio Power Appendix as recommended by FirstEnergy" and showing in redline format the FES objection to $188.88/MW-day embedded costs).) Thus, FES argued that the appendix should be revised to eliminate the inconsistent portion. (*See* FES Response, pp. 6-7 (citing 134 FERC ¶ 61,036, at ¶¶ 14, 20, 24).)

AEP Ohio agreed with FES' requested modifications to the proposed appendix and agreed to remove language referring to anything beyond the RPM-based charge to CRES suppliers for capacity. FERC Order, ¶ 20. As a result, FES' issues before the FERC were effectively resolved: the FERC Order only approved a market-based wholesale rate for AEP

Ohio's FRR capacity committed to shopping load. FES has no reason to further contest the FERC Order and claim preclusion does not apply.

Neither does the "supremacy" of the FERC tariff bar FES' challenges here. (*See* AEP Ohio Br. p. 11.) The operative FERC tariff, including the amended and approved appendix, only allows AEP Ohio to impose a wholesale charge that is equivalent to the RPM, market-based rate. *See* FERC Order, ¶ 14. What remains at issue is the PUCO's creation of an additional, above-market retail charge for a competitive service that threatens to undermine the FERC-recognized benefits of the PJM capacity market design and Ohio's competitive market for retail electric generation service. This issue is properly before this Court.

Moreover, AEP Ohio overlooks that under Ohio law FES has a right to appeal the PUCO's order to this Court. There is no dispute that the PUCO issued a final order establishing a compensation mechanism for AEP Ohio's capacity. That order was the subject of an application for rehearing by FES. That application was denied. Thus, the PUCO's capacity rulings constitute a final appealable order and thus may be properly appealed to this Court. R.C. § 4903.13.

B. FES PROPOSITION OF LAW NO. 2: The PUCO Lacks The Authority Under Ohio Law To Approve Above-Market Revenue For An Incumbent Electric Utility's Generating Assets.

Ohio law establishes two types of electric services: competitive and noncompetitive. Electric generation service is competitive and customers may receive generation service from any registered provider in their area. R.C. §§ 4928.01(A)(28)', 4928.03. Electric distribution service is the only remaining noncompetitive service; customers can only receive distribution service from the one utility in their area. *See* R.C. § 4928.03 .

The PUCO's state compensation mechanism for AEP Ohio is unlawful and unreasonable because it treats AEP Ohio's competitive, generation-related capacity service as a noncompetitive service and provides cost-of-service compensation to legacy generation assets that must be on their own in the competitive market. The PUCO's state compensation mechanism for AEP Ohio guarantees AEP Ohio the right to recover above-market revenue for its capacity, which should be subject to the competitive market and placed on a level playing field with all other capacity suppliers. Appellees' countervailing arguments – found in AEP Ohio Propositions of Law No. II and V, and PUCO Propositions of Law No. I and III – are unsupported and unpersuasive.

1. The PUCO's decision authorizing a capacity rate of $188.88/MW-day is before this Court.

The propriety of the PUCO's approval of above-market revenue should not be heard in the context of AEP Ohio's ESP II appeal process. (*See* PUCO Br., p. 36-43; AEP Ohio Br., pp. 30-32.) Here, the issue is the PUCO's Order authorizing AEP Ohio to recover $188.88/MW-day for its capacity (FES Appendix ("Appx.") 48), not the method under which the deferral of a portion of that rate will be charged to customers. The PUCO unquestionably authorized AEP Ohio to recover its full embedded costs in Case No. 10-2929-EL-UNC. The capacity price which AEP Ohio will ultimately receive is above and beyond the RPM, market-based price for capacity – and, in fact, nearly double the amount received by all other capacity suppliers. (*See* Supp. 27; Appx. 49 (the "Commission directs that the state compensation mechanism shall be based on the costs incurred by the FRR entity for its FRR capacity obligations"); Appx. 59 (authorizing $188.88/MW-day as AEP Ohio's "costs").) Thus, the decision to authorize AEP

Ohio to recover more than the RPM, market-based price for capacity is appropriately before the Court now.

2. The above-market revenue is unlawful and unreasonable because capacity is a competitive generation-related service that must be subject to market pricing.

(a) Under Ohio law, capacity is a competitive service by definition; AEP Ohio cannot unilaterally change the nature of the service.

Both the PUCO and AEP Ohio argue that because AEP Ohio is the only provider of capacity in its service territory, capacity is *ipso facto* a noncompetitive service there. (*See* PUCO Br., p. 4; AEP Ohio Br., p. 14.) This argument, of course, implicitly acknowledges that capacity: (a) was competitive before AEP Ohio elected to be an FRR entity; and (b) will be again as of June 1, 2015, when AEP Ohio's FRR entity status ends. Thus, if AEP Ohio and the PUCO are correct, AEP Ohio's actions changed the nature of the service under Ohio law. Neither AEP Ohio nor the PUCO explain how this could happen. Nor could they, given that it defies logic. AEP Ohio cannot operate in a competitive market, decide it wants to be a monopoly provider, and remove itself from the obligations and economic incentives attendant in a competitive market. The FRR provisions of the RAA did not provide AEP Ohio with an escape hatch from market-based compensation. As noted, if they did, the RPM will cease to exist because all rational suppliers would seek to escape market-based prices in favor of higher, embedded cost-based prices.

Under Ohio law, generating capacity – the assets – remain competitive regardless of AEP Ohio's efforts to monopolize the sale of capacity to CRES providers as an FRR entity. All electric distribution utilities ("EDUs") in Ohio completed their market transition periods long ago, which means that the generation assets of all EDUs (and all other generation assets operating in Ohio) are exposed, by statutory mandate, to the competitive market. *See* R.C. §

4928.38. Moreover, simply because AEP Ohio voluntarily agreed to commit capacity resources to the load in its service area does not mean that AEP Ohio somehow eliminated the capacity market. All of its legacy generation is in that market. Even after designating itself as an FRR entity, AEP Ohio had several options. It could have offered its capacity on the PJM market through the RPM auctions or bilateral transactions. If it had done so, it could have similarly purchased capacity to fulfill its FRR obligation. Or it could have used some or all of its capacity to fulfill its FRR obligations, leaving the remainder, if any, to be sold in the market. Although AEP Ohio is the one entity responsible for committing capacity resources in its service area until May 31, 2015, how it does so is up to AEP Ohio and the capacity market continues to function and remains competitive both before and after that date.

Further, the capacity provided by AEP Ohio is no different than the capacity provided anywhere else in Ohio or anywhere else in PJM. (*See* Tr. Vol. VIII, pp. 1606-08.) The only difference is that AEP Ohio chose to box all other capacity suppliers out of its distribution service territory.[1] Under AEP Ohio's and the PUCO's logic, capacity would be a competitive service in certain utility service territories where there is no FRR provider, but noncompetitive in AEP Ohio's service territory. That makes no sense. Capacity is a competitive service by

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[1] To be sure, under the RAA, once AEP Ohio elected to become an FRR entity, CRES providers operating in AEP Ohio's territory had the theoretical right to opt out of AEP Ohio's supply and seek to supply their own capacity. (Supp. 12.) Given that AEP Ohio initially committed to receive RPM-based capacity prices as an FRR entity, CRES providers had no incentive to seek their own supply. (Supp. 12.) By the time that AEP Ohio revealed its intent to seek higher, embedded cost-based capacity prices, CRES providers were effectively locked into receiving AEP Ohio's supply and could not opt out. (Supp. 12 (showing that "the earliest period an LSE could elect to self supply is for the 2015/16 Planning Year, beginning June 1, 2015").)

definition in Ohio law and that definition applies equally across the state.[2] The PUCO should not be allowed to reward AEP Ohio for acting to procure a monopoly by showering AEP Ohio with above-market, guaranteed revenues for the same service provided by all other capacity providers.

(b) Capacity and the PUCO's state compensation mechanism for AEP Ohio encompass a retail service and a retail charge.

The PUCO argues that capacity is a wholesale service and thus cannot by definition be a competitive retail service. (*See* PUCO Br., p. 16.) But at the same time, the PUCO repeatedly asserts that its state compensation mechanism for AEP Ohio's capacity includes a wholesale <u>and</u> a retail component. (*See, e.g.,* PUCO Br., pp. 3, 39.) How can a charge that has a retail component not involve a retail service? The PUCO also admits that "capacity is a component of generation necessary to provide competitive retail electric service to customers." (PUCO Br., p. 17.) If so, then capacity falls squarely within the definition of a retail electric service under Ohio law.[3] Under Revised Code Section 4928.01(A)(27), "retail electric service" is defined to include "any service involved in supplying or arranging for the supply of electricity to ultimate consumers in this state, from the point of generation to the point of consumption". Because

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[2] AEP Ohio states that "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." (AEP Ohio Br., p. 14.) AEP Ohio provides no authority for the idea that a party must specifically challenge a concurring (or dissenting) opinion, which is not an opinion of the PUCO as a whole. Nor could it.

[3] The PUCO again argues from two sides when it suggests that capacity is not a retail service because "capacity is not consumed." (PUCO Br., p. 16.) This is both overly simplistic and irrelevant to the application of the General Assembly's definition of the scope of retail electric service. Capacity, as the PUCO earlier admits, is a necessary component of providing generation service to consumers in Ohio.

capacity is a "component" of generation service, it is a service "involved" in supplying generation.

The PUCO does not provide any legal or record citation to explain its assertions that "the capacity in this case is different" or capacity is "wholesale by definition." (PUCO Br., p. 17.) It appears that the PUCO's argument rests solely on the notion that because capacity is provided to CRES providers and not end users, the service is wholesale. The definition of retail electric service is not so constrained. Further, this argument is belied by: (a) the PUCO's admission that capacity contains a retail component; and (b) the establishment of a retail charge for capacity (to be determined in AEP Ohio's electric security plan ("ESP") proceeding).

AEP Ohio's arguments on this point similarly fail. AEP Ohio provides no citations to law or evidence to support its argument that capacity is wholesale rather than retail. Instead, AEP Ohio argues that the Ohio statutes that reference capacity do not apply because the statutes are found in Chapter 4928, which deals with competitive retail electric service "and the wholesale capacity service sold to CRES providers is *neither* competitive *nor* retail." (AEP Ohio Br., p. 16 (emphasis in original); R.C. §§ 4928.142(C), 4928.143(B)(2)(a), and 4928.20(J).) AEP Ohio misses the point. The General Assembly's discussion of capacity in Chapter 4928 shows that the General Assembly intended capacity to be treated the same as all of the other generation-related components of retail electric service.

AEP Ohio contends that FES did not explain why, if capacity was a wholesale, noncompetitive service, numerous Ohio statutes would be rendered meaningless. (AEP Ohio Br., p. 16, citing FES Br., p. 29.) AEP Ohio ignores the pages in FES' brief that provide that explanation. (*See* FES Br. pp. 26-31.) In any event, Chapter 4928 requires a competitive market for retail electric service and the elimination of cost-of-service regulation for utilities' electric

generating assets – both of which preclude the PUCO from guaranteeing AEP Ohio full embedded cost recovery for the capacity provided by AEP Ohio's generating assets. For example, Revised Code Section 4928.02 enumerates state policies, including requirements that the PUCO "[e]nsure effective competition in the provision of retail electric service by avoiding anticompetitive subsidies flowing from a noncompetitive retail electric service to a competitive retail electric service or to a product or service other than retail electric service" and that the PUCO "[e]nsure retail electric service consumers protection against . . . market power." R.C. § 4928.02(H), (I). AEP Ohio believes that it could use its position as the incumbent utility to self-select out of the competitive market for capacity by electing FRR status and then claim that capacity was no longer competitive in its service territory. If the PUCO could, as a result, declare that it could authorize AEP Ohio to collect above-market revenue from all of its customers (directly for nonshopping customers and through CRES providers for shopping customers), the State's policies would be meaningless. The State's policy of ensuring availability of reasonably priced electric service also would be meaningless because under the PUCO's state compensation mechanism customers would be unnecessarily and improperly burdened with significantly above-market prices for capacity when market-priced suppliers are available to supply capacity.

Similarly, Revised Code Section 4928.17 requires Ohio utilities to separate their noncompetitive retail electric service from their competitive retail electric service ("or any other product or service other than a retail electric service"). If AEP Ohio's continued ownership of generation facilities – facilities which supposedly cannot be financially supported by market-based capacity prices – can be the basis for AEP Ohio's ability to receive above-market capacity pricing, the General Assembly's requirements for corporate separation would be meaningless as

applied to AEP Ohio. Because AEP Ohio's generation should have already been separated, AEP Ohio's ownership cannot be a basis for the relief the PUCO has provided. Otherwise, AEP Ohio, by flaunting the law, would gain an improper advantage.

Further, Sections 4928.37-.40, which set forth the General Assembly's limitations on transition revenues (and are discussed further below), would also be meaningless. The PUCO's state compensation mechanism would allow AEP Ohio to receive further revenues for a transition to market that should have been complete as of 2008. (Supp. 177, 193-94 [FES Ex. 106, ETP Stipulation]; R.C. § 4928.38.) The PUCO's state compensation mechanism's authority for AEP Ohio to recover above-market revenue for its generation-related capacity service is inconsistent with Ohio law and policy, and is, therefore, unlawful and unreasonable.

3. The PUCO's state compensation mechanism includes transition revenues prohibited by statute.

The PUCO attempts to discount the connection between the state compensation mechanism and AEP Ohio's transition to market. (PUCO Br., pp. 33-36.) At best, this reflects form over substance. The PUCO argues that the revenues are not transition revenues because AEP Ohio never sought authorization to impose transition charges on shopping customers. (PUCO Br., p. 34.) But AEP Ohio itself described its request for a cost-based capacity price as an "exit" fee for "customers exiting our regulated environment" and shopping in the competitive market. (Tr. Vol. II, pp. 408-410.) Further, the state compensation mechanism's design and purpose are no different from the transition charge no longer permitted under Ohio law.

The PUCO also tries to describe the transition revenues it is prohibited from granting AEP Ohio (and all other utilities) as limited to charges for "electricity." Because this proceeding involves capacity, the PUCO contends, this case has nothing to do with transition revenues.

(PUCO Br., p. 34.) The PUCO cites no authority to support its view that transition charges are limited to "electricity." Not surprisingly, the relevant statutes do not provide any basis to limit transition charges on that basis. The PUCO also cites its opinion below and argues that because "there is nothing about stranded costs in the [PUCO's] analysis," then the PUCO's Order must not involve transition revenues. (PUCO Br., p. 35.) Regardless of how the PUCO or AEP Ohio describe the costs and charges at issue, neither can change the bases of the state compensation mechanism's above-market revenue. Simply put, AEP Ohio argued and the PUCO found that the reason why AEP Ohio should receive above-market prices was that such compensation was necessary for AEP Ohio's transition to the competitive market. As the PUCO stated:

> [W]hile the [Rate Stability Rider] and the inclusion of the deferral [of the above-market piece of the state compensation mechanism] within the RSR are the most significant cost associated with the modified ESP, **but for the RSR it would be impossible for AEP Ohio to completely participate in full energy and capacity based auctions beginning in June 1, 2015. . . [T]here is no doubt that AEP Ohio would not be fully engaged in the competitive marketplace by June 1, 2015 [if AEP Ohio does not receive the terms and conditions of the ESP, including the RSR].**

(PUCO Br., p. 40 (citing ESP 2 Order, p. 76) (emphasis added).)

The PUCO's explanation thus begs this question: how can a charge ostensibly designed to allow AEP Ohio ultimately to participate in the competitive market faster and more effectively not be considered a charge levied for the purpose of transitioning AEP Ohio to a competitive market? This Court has previously described transaction costs as "represent[ing] regulatory assets and other costs incurred by the utility under regulation that will not be recovered in a competitive environment." *FirstEnergy Corp. v. Pub. Util. Comm.*, 95 Ohio St. 3d 401, 405, 2002-Ohio-2430, ¶14 (emphasis omitted). Here, AEP Ohio claims that its embedded generation

costs, which were incurred mostly under regulation, would not be recovered through market-based pricing. AEP Ohio Brief, pp. 28-29. Ohio law prohibits the recovery of these costs now by any means other than market prices. Once AEP Ohio's right to transition revenues terminated (which occurred for in 2008), AEP Ohio was required to "be fully on its own in the competitive market." R.C. § 4928.38. AEP Ohio is not entitled to any further assistance from the PUCO. Indeed, AEP Ohio voluntarily waived any right to impose a lost revenue charge to recover the difference between market pricing and its full embedded costs. (Supp. 176, 209.) Thus, the above-market revenue included in the state compensation mechanism is unlawful and unreasonable.

4. The PUCO's decision will adversely affect competition.

A key component of both the PJM and Ohio retail markets is the benefit of competition to customers. Competitive markets are characterized by price-setting applied similarly to all sellers. The PUCO's Order upsets that balance by giving AEP Ohio and its affiliate AEP Generation Resources (scheduled to receive AEP Ohio's generation assets) advantages that other suppliers don't have. In defense of this thumb-on-scale benefit to AEP, the PUCO and AEP Ohio suggest that AEP Generation Resources is entitled to receive the above-market state compensation mechanism because: (1) AEP Ohio retains the obligation to provide capacity as the FRR entity; and (2) the same assets are providing the capacity. (PUCO Br., p. 29; AEP Ohio Br., p. 19.) However, nothing requires that AEP Ohio satisfy its FRR capacity obligations via generation from AEP Generation Resources. AEP Ohio could satisfy its FRR obligation in a number of other ways, including buying capacity through market purchases. Simply because AEP Ohio decided to procure its capacity through an affiliate should not entitle the unregulated, competitive affiliate to above-market revenue.

Both the PUCO and AEP Ohio also suggest that FES should have no concerns about the state compensation mechanism because CRES providers are only charged the applicable RPM price for capacity. Those suggestions ignore the fact that the state compensation mechanism's above-market price will disrupt the competitive market. For example, both FES and AEP Generation Resources, as generation suppliers, will compete in the energy market. The additional revenue that AEP Ohio – and later AEP Generation Resources – will receive through the state compensation mechanism provides an advantage to those participants in the competitive energy market. AEP Generation Resources will receive revenues that no other PJM capacity supplier will receive. AEP Ohio and AEP Generation Resources, by receiving higher-than-market revenue for capacity in Ohio, will have the ability to offer energy at a lower price. (*See* Supp. 81-82.) Certainly, at a bare minimum, AEP Ohio's affiliate should not be entitled to receive anything more than any other unregulated, competitive capacity supplier: the RPM, market-based price for capacity.

AEP Ohio and AEP Generation Resources may also compete with FES for capacity in PJM auctions or in the bilateral capacity market. With additional revenues not available to other capacity suppliers, AEP Ohio and AEP Generation Resources may also be able to reduce their price offers for capacity outside of AEP Ohio's service territory.

Moreover, the above-market pricing AEP Ohio will receive is nothing more than an impermissible subsidy. AEP Ohio's own witness admitted that by receiving above-market revenue, AEP Ohio could subsidize its competitive generation <u>and</u> non-competitive distribution services: "It will allow us to make investments in our generation plants as it will in our distribution because, again, we are a bundled company." (Tr. Vol. I, p. 79.) Such subsidies are not allowed under Ohio law. R.C. § 4928.38.

5. Because capacity is not a POLR obligation, the PUCO's authority to set a POLR charge is irrelevant.

In its Brief, the PUCO asserts, for the first time, that it has the authority to set a capacity rate because it has authority to set provider of last resort ("POLR") charges. (PUCO Br., pp. 23-25.) But capacity – whether provided by an FRR entity or any other supplier – is not a POLR service. As this Court has noted, the "obligation to stand ready to accept returning customers makes the utility the 'provider of last resort,' or 'POLR.'"[4] *In re Application of Columbus S. Power Co.*, 128 Ohio St.3d 512, 2011-Ohio-1788, 947 N.E.2d 655, ¶ 23 citing *Constellation NewEnergy, Inc. v. Pub. Util. Comm.*, 104 Ohio St.3d 530, 2004-Ohio-6767, 820 N.E.2d 885. Capacity is distinguishable from POLR service in several ways. First, capacity is not a service that either customers or CRES providers can opt out of; all customers must acquire capacity from AEP Ohio because of its FRR election. Second, AEP Ohio does not face any "risk" associated with customers leaving its capacity service or seeking to return to its capacity service when market prices change.[5] Third, AEP Ohio's FRR status also is not the result of any statutory obligation. AEP Ohio voluntarily elected to sign up to provide capacity for all customers in its service territory.

And even if the PUCO was correct and capacity was a POLR service, the argument still does not support the PUCO's position. POLR service is a retail service and, thus, so too would

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[4] This Court has also "admonished" the PUCO to "'carefully consider what costs it is attributing' to 'POLR obligations.'" *Id.* at ¶ 23 (*quoting Ohio Consumers' Counsel v. Pub. Util. Comm.*, 114 Ohio St.3d 340, 2007-Ohio-4276, 872 N.E.2d 269, ¶ 26).

[5] Although CRES providers, at one time, had the opportunity to opt out of AEP Ohio's service, they cannot do so now for the period relevant here. (Supp. 12.)

be AEP Ohio's capacity. Either way, the PUCO's attempt to bootstrap AEP Ohio's capacity price to a utility POLR charge should be rejected out of hand.

6. Capacity is not subject to traditional rate regulation and AEP Ohio has no "right" to revenue for its capacity that was or could be confiscated.

The PUCO suggests two "tests" that it feels compelled to apply to determine AEP Ohio's capacity price. Neither is based in Ohio law. First, the PUCO asserts that it must "fairly compensate" AEP Ohio for its costs. (PUCO Br., p. 1.) The PUCO has an "obligation under traditional rate regulation to ensure that Ohio's jurisdictional utilities, like AEP-Ohio, have an opportunity to earn just and reasonable compensation for their services." (PUCO Br., p. 47.) Both descriptions reflect the obsolete, pre-2000 rate regulation imposed on vertically integrated utilities and established in Chapter 4909. *See, generally,* R.C. Ch. 4909. However, Ohio law now specifically provides that "**a competitive retail electric service supplied by an electric utility** or electric services company **shall not be subject to supervision and regulation by the public utilities commission under Chapters 4901. to 4909**," except for limited service reliability standards. R.C. § 4928.05(A) (emphasis added). Generation assets are no longer part of an electric utility's rate base but are now, and have been for some time, on their own in the competitive market. R.C. § 4928.38. The PUCO cannot apply traditional rate regulation to AEP Ohio's capacity because it is a competitive retail electric service. Cost-recovery, including the opportunity to earn a fair rate of return, is limited to noncompetitive, distribution service.

Further, the PUCO improperly considered AEP Ohio's return-on-equity for its distribution and generation assets in setting the state compensation mechanism. AEP Ohio notes FES' point on this issue. (AEP Ohio Br., p. 17.) But neither AEP Ohio nor the PUCO deny or provide any rebuttal to that fact, which, alone, should cause the Court to reject the PUCO's rate

of return analysis. Ohio law precludes any mixing of noncompetitive distribution assets with competitive generation assets and any subsidies flowing between the two. *See* R.C. §§ 4928.02(H), 4928.17.

Notably, even if a "just and reasonable" standard applied to judge AEP Ohio's capacity prices, the PUCO's decision is wrong. The FERC expressly found that RPM produces "just and reasonable rates." *In re PJM Interconnection, LLC,* 121 FERC ¶ 61,173 at ¶ 3 (2007) (quoting *In re PJM Interconnection, LLC,* 119 FERC ¶ 61,318 at ¶ 191). The FERC noted that using a just and reasonable standard does not require approving rates that are cost-based. *Id.* at ¶ 31. The FERC observed that prices based on competitive markets can produce advantages to customers in comparison to cost-of-service regulation. *Id. at* ¶ 32. These advantages arise from market incentives that force sellers to be more efficient and to keep their prices as low as possible. *Id.* Given the competitive nature of the capacity market and the retail electric generation market in Ohio, embedded cost recovery is an improper measure to determine the reasonableness of competitive service rates.

C. FES PROPOSITION OF LAW NO. 3: The PUCO Must Follow The Procedures Set Forth In Revised Code Chapter 4909 In Order To Set A Cost-Based Rate For Electric Service.

Having invoked Revised Code Chapter 4909 to justify its authority to set AEP Ohio's capacity rate, the PUCO must follow the procedures set forth in that Chapter. The PUCO, however, believes that it may pick and choose what procedures in Chapter 4909 to apply, notwithstanding this Court's description of those procedures as "mandatory." The PUCO and AEP Ohio would have the Court disregard the PUCO's deviations from those "mandatory" procedures in this proceeding as, essentially, "close enough." Ohio law and this Court's precedent provide otherwise.

The PUCO does not have the authority under PJM's RAA or Ohio law to set an embedded-cost based rate for AEP Ohio's capacity. But, if the PUCO does have such authority, Chapter 4909 is the only authority by which the PUCO could establish such a cost-based rate. Chapter 4909 sets the procedures and the formula for establishing a "just and reasonable rate." R.C. § 4909.15; *Indus. Energy Users-Ohio v. Pub. Util. Comm.*, 117 Ohio St.3d 486, 2008-Ohio-990, 885 N.E.2d 195, ¶ 28 ("R.C. Chapter 4909 governs the commission's power to set utility rates and charges."). This Court has repeatedly affirmed that limitation and the need for the PUCO to comply with the requirements of Chapter 4909 in setting utility rates. "While the General Assembly has delegated authority to the [PUCO] to set just and reasonable rates for public utilities under its jurisdiction, it has done so by providing a **detailed, comprehensive and, as construed by this court, mandatory ratemaking formula under R.C. 4909.15**." *Columbus So. Power Co. v. Pub. Util. Comm.*, 67 Ohio St.3d 535, 537, 620 N.E.2d 835 (1993) (citing *Gen. Motors Corp. v. Pub. Util. Comm.*, 47 Ohio St.2d 58 (1976)) (emphasis added); *City of Cleveland v. Pub. Util. Comm.*, 164 Ohio St. 442, 443, 132 N.E.2d 216 (1956) ("[T]he statutes of this state and the decisions of this court indicate that the [PUCO] must" adhere to the requirements of Chapter 4909, including R.C. § 4909.15). The PUCO and AEP Ohio improperly attempt to blur the statute's and the Court's unambiguous requirements by pointing to other statutes that are silent as to any ratemaking authority and to other proceedings that are unrelated to the capacity service at issue here.

1. **Revised Code Section 4905.26 provides the PUCO with an option as to how to *initiate a proceeding* to assess whether a rate is unjust and unreasonable – not blanket authority as to how to set a new rate where the current rate is found to be unjust and unreasonable.**

The PUCO argues that it has the authority institute a new rate – any new rate – by virtue of the authority provided it by Revised Code Section 4905.26. But that statute and the case law relied on by the PUCO do not provide support for the PUCO's position. To the contrary, the PUCO's cases affirm that: (1) the PUCO's authority under Section 4905.26 is limited to the initiation of a proceeding and following the procedural requirements of a hearing; and (2) the PUCO must look to the separate procedures expressly in Section 4909.15 to fix a new rate in a proceeding initiated under Section 4905.26.

The most significant and illustrative of the cases relied on by the PUCO is *Ohio Utilities Company v. Pub. Util. Comm.*, 58 Ohio St.2d 153, 389 N.E.2d 483 (1979). (*See* PUCO Br., pp. 12-13.) In that case, the Court affirmed the PUCO's right to initiate a proceeding to assess the reasonableness of a rate under Section 4905.26. But the PUCO established a new rate in that proceeding using the "mandatory" procedures of Section 4909.15. *Ohio Utilities* at 154-155. Specifically, the Court held:

> If, after an investigation and hearing pursuant to R.C. 4905.26, the [PUCO] determines that existing rates charged by a utility are unjust or unreasonable, the commission can invoke its authority under R.C. 4909.15(D) to fix new rates and order them to be substituted for the existing ones." [*Id.* at p. 153, syl. 1.]

That is exactly what the PUCO must do here. If the PUCO determined that AEP Ohio's proposed capacity rate was unjust or unreasonable as a result of a Section 4905.26 proceeding, the PUCO must then fix a new rate using the procedures set forth in Section 4909.15.

The PUCO inflates the Court's use of "can" and "could" in referring to the ratemaking procedures of Section 4909.15 into a grant of unilateral discretion to the PUCO to decide, at its whim, whether to use the otherwise described "mandatory" Section 4909.15 ratemaking procedure. (*See* PUCO Br., p. 13.) This is wrong. In *Ohio Utilities,* the Court was not presented with the question as to whether the PUCO must follow the requirements of Section 4909.15 in setting a new rate. In numerous other decisions, however, the Court when presented with the issue has held the ratemaking procedures are "mandatory." *See, e.g., Columbus So. Power Co. v. Pub. Util. Comm.,* 67 Ohio St.3d 535, 537, 620 N.E.2d 835 (1993); *City of Cleveland v. Pub. Util. Comm.,* 164 Ohio St. 442, 443, 132 N.E.2d 216 (1956). In any event, the Court could not alter the General Assembly's express requirement in Section 4909.15 that the PUCO "shall" make certain determinations set forth in that section "when fixing and determining just and reasonable rates." R.C. § 4909.15(A). To the extent that the Court's language in *Ohio Utilities* can be described as permissive, it merely recognizes that as a result of a Section 4905.26 proceeding, the Commission has certain options: (1) the PUCO can determine that the rate in question is just and reasonable and, therefore, do nothing; (2) the PUCO can determine that the rate is not just and reasonable and simply eliminate the rate in question; or (3) the PUCO can determine that the rate is not just and reasonable, and use the Section 4909.15 procedures to fix a new rate. Nevertheless, the language of Section 4909.15 is clear: if the PUCO seeks to fix a just a reasonable rate, "[t]he public utilities commission, when fixing and determining just and reasonable rates, fares, tolls, rentals, and charges, **shall** determine" the information required by the "mandatory" ratemaking formula set forth in that section. (Emphasis added.)

Like *Ohio Utilities*, the other cases cited by the PUCO are similarly focused on the PUCO's authority to initiate an investigation, as opposed to the authority or requirements for

setting a new rate. As a result, the other citations also do not support the relevant issue here. Two cases suffice. In *Ohio Consumers Counsel v. Pub. Util. Comm.*, 110 Ohio St.3d, 394, 2006-Ohio-4706, 853 N.E.2d 1153 (PUCO Br., p. 9), Consumers' Counsel argued that the utility should have been required to follow the requirements associated with a utility-initiated proceeding under Revised Code Section 4909.18. These requirements include that the utility file a written application (R.C. § 4909.18), publish notice of the application in newspapers of general circulation (R.C. § 4909.19), and conduct public hearings in each affected municipal corporation (R.C. § 4309.038) in order to establish or change a rate. *See Ohio Consumers' Counsel*, ¶ 26. This Court held that, because the proceeding was initiated under Section 4905.26, via a complaint filed by an affected CRES provider, the requirements for a utility-initiated proceeding did not apply. *Id.* at ¶¶ 28-32. "We have repeatedly held that utility rates may be changed by the PUCO in an R.C. 4905.26 complaint proceeding such as this, without compelling the affected utility to apply for a rate increase under R.C. 4909.18." *Id.* at ¶ 29 (emphasis added); *see also* ¶ 32 (noting the PUCO's compliance with the procedural requirements of Section 4905.26). Notably, that case does not address how the PUCO may set the new rate, only how it may initiate the proceeding. Thus, it is irrelevant here.

Another decision relied upon by the PUCO, *Allnet Communications Servs., Inc. v. Pub. Util. Comm.*, 32 Ohio St.3d 115, 512 N.E.2d 350 (1987) (PUCO Br., p. 9), is similarly not relevant. In that case, an affected party filed a complaint under Section 4905.26 to challenge a rate imposed by a local telephone utility. The utility argued that the affected party could not challenge the rate under Section 4905.26 and was instead required to have filed an application for rehearing in the earlier rate proceeding. *Allnet* at 116. The PUCO dismissed the affected party's complaint as a collateral attack on the earlier rate determination. The Court, however,

reversed the PUCO's dismissal and held that the affected party was entitled under Section 4905.26 to challenge the reasonableness of the utility's implementation of the rate determination. *Id.* at 117-118. The Court noted, as relied on by the PUCO here, that "R.C. 4905.26 is broad in scope as to what kinds of matters may be raised by complaint before the PUCO." *Id.* at 117 (emphasis added).

This decision does not support the PUCO's argument that it has unfettered authority to set any new rate it deems reasonable by initiating a proceeding under Section 4905.26. The *Allnet* decision simply supports the PUCO's undisputed right to institute such a proceeding. But neither Section 4905.26 nor *Allnet* change the mandatory language of Section 4909.15 regarding how to set a new rate.

2. AEP Ohio's distribution rate case is irrelevant to this wholly separate proceeding regarding the rate applied to AEP Ohio's generation-based capacity.

The PUCO also argues that either it has complied with or should not be required to comply with the Section 4909.15 procedures because this proceeding "was decided only seven months after new distribution rates were established for AEP-Ohio" in AEP Ohio's separate distribution rate case. (*See* PUCO Br., p. 13.) The PUCO shockingly suggests that "[i]t would have been pointless to have reproduced the same analysis that the Commission had just completed in AEP-Ohio's distribution cases." (*Id.*) This argument confirms that the PUCO has lost sight of the requirements for separate treatment of distribution and generation functions. The equipment and facilities required for the noncompetitive, regulated distribution function – *e.g*, substations, transformers, poles, and lines – are totally distinct from the equipment and facilities required for the competitive, unregulated generation function – *e.g.*, electric generating facilities, power plants, and fuel. The procedures of Section 4909.15 require the PUCO to value

the utility's property over a test period. The property at issue in a distribution rate case is wholly different from that in a generation rate case. *See* R.C. § 4909.15(A). The value and expected rate of return for AEP Ohio's generating facilities, which provide capacity, should not have been of any consideration in setting AEP Ohio's distribution rates. Ohio law requires that those two groups of assets be separated. AEP Ohio's generating facilities should be legally separate from its distribution facilities – and, at the very least, accounted for separately on AEP Ohio's books. *See* R.C. § 4928.17 (requiring utilities to, among other things, implement separate accounting requirements and a code of conduct to ensure functional separation of competitive and noncompetitive services). The PUCO's assertion that it recently valued AEP Ohio's distribution-related property, rendering another rate case unnecessary, underscores the fact that the PUCO has overstepped its statutory bounds in setting AEP Ohio's rate for capacity.

3. AEP Ohio's arguments relating to a "full base rate case" and a "first filing" are inaccurate and irrelevant.

In response to the PUCO's need to adhere to the requirements of Section 4909.15, AEP Ohio raises a number of issues that are of no consequence. For example, AEP Ohio dismisses the need for a "full-blown base rate case" because the PUCO "did not actually set base rates" and because the proceeding below "was not a traditional base rate case." (*See* AEP Ohio Br., p. 28.) These assertions miss the mark. As an initial matter, there is no reference or limitation in Chapter 4909 to "base rates." Instead, the procedures in Section 4909.15 broadly encompass "just and reasonable rates, fares, tolls, rentals, and charges." R.C. § 4909.15(A). "Base rates" colloquially refer to rates for distribution service. Because the rates at issue here deal with capacity – as a service distinct from distribution – AEP Ohio's reference to "base rates" makes no sense.

AEP Ohio also argues that the underlying proceeding "could properly be construed as a 'first filing' of rates." As such, AEP Ohio implies the PUCO need not apply the mandatory ratemaking formula required by R.C. 4909.15. (*See* AEP Ohio Br., p. 29.) This argument is disingenuous. There is nothing new about AEP Ohio charging a capacity rate, which it has done on behalf of all customers in its service territory since it became an FRR entity in 2007. (AEP Ohio Ex. 101, Direct Testimony of Richard E. Munczinski, at pp. 5-6.) Indeed, AEP Ohio charged the RPM price for its capacity while it was an FRR entity, from 2007 until the effective date of the PUCO's Order. (*See id.*) Indeed, in its December 2010 Order initiating this proceeding, the PUCO affirmed that a state compensation mechanism already was in effect before the PUCO's Order setting the above-market state compensation mechanism. (Appx. 6-7 ("expressly adopt[ing]" a state compensation mechanism set at the RPM price).)

Moreover, the only statute that makes any kind of distinction based on whether the rate represents an increase (versus a "first filing") is, as AEP Ohio's Brief acknowledges, Revised Code Section 4909.18. But that statute applies only to proceedings initiated by a utility's application. Notably, that is the very type of proceeding that the PUCO seeks to distinguish from this one, which was initiated under Section 4905.26. *See* R.C. § 4909.18 ("Any public utility desiring to establish any rate . . . or rental, or to modify, amend, change, increase, or reduce any existing rate . . . shall file a written application with the [PUCO].") Thus, AEP Ohio's argument should be rejected out of hand.

AEP Ohio's futile attempts to minimize a statutory requirement are best illustrated by its claim that the PUCO "used <u>a</u> traditional (if not <u>the</u> traditional) means of determining compensation." (AEP Ohio Br., p. 12 (emphasis added).) Thus, AEP Ohio suggests, simply because the PUCO used "a" method of setting AEP Ohio's capacity rate, the fact that it was not

"the" statutory method should not matter. By definition, that is not how statutory requirements work. Requirements are requirements. The PUCO had no authority to apply traditional rate principles to guarantee revenue for a generation-related service, but if it did, it was required to follow "the" traditional and mandatory ratemaking formula called for by Section 4909.15.

4. Appellees' contrary propositions of law should be rejected.

AEP Ohio's Proposition of Law No. IV seeks to establish that the PUCO "correctly determined that a full base rate case proceeding was not required here." (AEP Ohio Br., pp. 28-29.) As discussed *supra*, that is not true. The formula provided for by Section 4909.15 must be followed if the PUCO seeks to establish a just and reasonable rate for utility service. The PUCO's Proposition of Law No. I seeks to establish that the PUCO had reasonable grounds to investigate and establish a new rate under Section 4905.26. (PUCO Br., pp. 9-32.) The PUCO supports that proposition with a number of wide-ranging arguments. FES does not challenge the PUCO's right to investigate AEP Ohio's proposed capacity rate under Section 4905.26, but FES does object,[6] as set forth in its Merit Brief and herein, to the PUCO's suggestion that it could "establish a new rate" based on purported authority in Section 4905.26 and while ignoring the requirements of Section 4909.15. Thus, to that extent, the PUCO's Proposition of Law No. 1 also should be rejected.

The PUCO's and AEP Ohio's Propositions of Law would effectively void Section 4909.15 of any meaning. Under their construction, the PUCO would have to follow the ratemaking formula to fix a just and reasonable rate if the utility asked for an increase (under Section 4909.18), but could decide not to apply the formula if the PUCO or a customer asked for

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[6] FES also objects to other of the PUCO's arguments in support of its Proposition of Law No. I, as set forth in Sections A and B, *supra*.

the review of a rate (under Section 4905.26). The language of Section 4909.15 and this Court's prior precedent is clear. If the PUCO seeks to fix a just and reasonable rate for a utility service, the PUCO "shall" apply the Section 4909.15 ratemaking formula in setting utility rates. Neither Appellee challenges the fact that the PUCO failed to apply the "detailed, comprehensive, and . . . mandatory ratemaking formula" to set AEP Ohio's capacity price. *Columbus So. Power Co.*, 67 Ohio St.3d at 537. Thus, even if the PUCO were authorized to set an above-market, cost-based rate for AEP Ohio's capacity, the PUCO's Order should be reversed because the PUCO failed to follow the proper procedures for setting a cost-based rate.

III. AEP OHIO'S CROSS-APPEAL LACKS MERIT.

A. Market-based rates are not confiscatory.

AEP Ohio argues in its Proposition of Law No. IX that if it is denied the ability to recover the above-market piece of the state compensation mechanism, that action would constitute a "regulatory taking." (AEP Ohio Br., pp. 47-49.) This argument assumes that AEP Ohio is entitled to above-market revenue or a reasonable rate of return for its capacity service. That is false. AEP Ohio, as a capacity supplier in PJM, provides capacity in a competitive market. AEP Ohio made a business decision to elect FRR status; AEP Ohio, along with its affiliates, believed the FRR election would be better for them than participating in the RPM auction process. (Tr. Vol. II, p. 394-97.) Unhappy with the current market price, AEP Ohio cannot change the rules of the game and seek unprecedented guaranteed revenues as if capacity was noncompetitive and subject to traditional rate regulation. The traditional rate regulation / rate-of-return analysis that the PUCO used to determine how much above-market revenue AEP Ohio should receive to "fairly compensate" for its capacity is provided for under Chapter 4909 and only applies to noncompetitive, distribution service.

Moreover, the U.S. Constitution does not guarantee AEP Ohio's profit margin. In *Hope*, the U.S. Supreme Court recognized that "regulation does not insure that the business shall produce net revenues" and furthermore that "the hazard that the [utility] will not earn a profit remains on the company in the case of a regulated, as well as an unregulated business." *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) (quoting *Fed. Power Comm. v. Natural Gas Pipeline Co.*, 315 U.S. 575, 590 (1942)); *see also Market Street Ry. Co. v. RR. Comm. of California*, 324 U.S. 548 (1945) (regulation does not insure a utility's profit). AEP Ohio is seeking to protect its generation assets from market pricing despite the twin statutory mandates that its assets be fully on their own in the competitive market and that retail ratepayers receive the benefits of competitive markets. Market-based pricing is, by definition, not confiscatory. Such pricing passes constitutional muster.

B. AEP Ohio's attempt to expand its above-market subsidy by challenging the energy credit should be rejected.

The PUCO granted AEP Ohio "cost based" capacity pricing that is more than double the applicable market rate and well in excess of anything contemplated by the RAA. Yet AEP Ohio complains in its Proposition of Law No. VIII that the PUCO's largesse is just not enough; it quibbles with the PUCO's calculation of the energy credit. While FES does not agree with the PUCO's decision to impose above-market pricing, AEP Ohio certainly offers no justification for changing the balancing of competing interests performed by the PUCO in calculating the energy credit.

As recognized by the PUCO, the cost of capacity is offset by revenue from energy sales. Thus, an energy credit is necessary if a cost-based capacity price is awarded. (Appx. 60.) FES offered expert testimony that a cost-based capacity price should not exceed $78.53/MW-day, but

the PUCO rejected this testimony simply because the PUCO wanted to give a larger above-market subsidy to AEP Ohio to support its financial well-being. (Appx. 59.) The PUCO concluded that an above-market subsidy of $188.88/MW-day was sufficient to allow AEP Ohio to earn an appropriate return on equity. (Appx. 61.) Indeed, the PUCO cited testimony that a charge of $145.79/MW-day would have been sufficient to bolster AEP Ohio's return on equity, but the PUCO decided to give AEP Ohio a comfortable cushion above that minimum. (Appx. 61-62.) By complaining about how the PUCO arrived at the $188.88/MW-day number, AEP Ohio is looking a gift horse in the mouth.

AEP Ohio argues that the PUCO used an incorrect shopping percentage estimate in its calculation (AEP Ohio Br., pp. 42-44), but AEP Ohio cannot demonstrate what the correct percentage would be: it is, after all, an estimate. Ironically, while AEP Ohio and the PUCO argue elsewhere that deferral issues are better addressed in AEP Ohio's ESP II proceeding, AEP Ohio fails to mention that the PUCO stated in that proceeding that it would review actual shopping statistics at the conclusion of the ESP and make appropriate adjustments to the rider through which AEP Ohio is collecting its $508 million above-market subsidy. (*See* Appendix to the First Merit Brief of the Office of Ohio Consumers' Counsel at 271 [Case No. 11-346-EL-SSO et al., Opinion and Order at p. 36 (Aug. 8, 2012)].) AEP Ohio also fails to demonstrate how incorrect estimates of shopping would prejudice it, given that the $188.88/MW-day rate provides it a more than ample above-market subsidy.

Similarly, none of the other criticisms of the PUCO's energy credit calculation lead to the conclusion that the $188.88/MW-day rate inadequately compensates AEP Ohio. AEP Ohio points to this Court's decision in *In re Application of Columbus Southern Power Co.*, 128 Ohio St.3d 512, 2011-Ohio-1788, 947 N.E.2d 655, but that case involved the misuse of a model, not

factual disputes over correct inputs to a model. The Court reversed the PUCO's decision in that case not because the *inputs* used in the Black-Scholes model were wrong, but rather because the model was not intended to be used to calculate POLR risk and was misused by AEP Ohio in that case. As the Court explained:

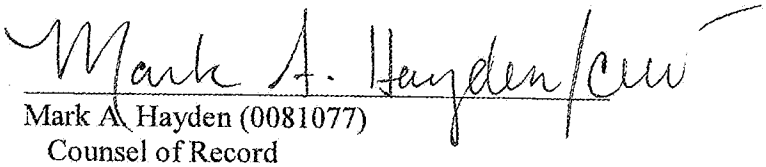
> [T]his formula simply does not reveal "the cost to the Companies to be the POLR and carry the risks associated therewith." The record shows that the model does not even purport to estimate costs, but instead tries to quantify "the value of the optionality [to shop for power] that is provided to customers under Senate Bill 221." Value to customers (what the model shows) and cost to AEP (the purported basis of the order) are simply not the same thing.

Id. at 518. AEP Ohio proposed its own energy credit calculation, but that calculation included errors that AEP Ohio could not explain and failed to account for AEP Ohio's corporate separation scheduled for the end of 2013. (Tr. Vol. I, pp. 270-79.) AEP Ohio cannot demonstrate that the subsidy amount awarded to it by the PUCO was too small.

IV. CONCLUSION

As set forth in FES' Merit Brief and in this Brief, the PUCO's Order authorizing AEP Ohio to receive an above-market revenue for its generating assets based on AEP Ohio's full embedded costs is unlawful and unreasonable. The Court should reverse the PUCO's decision authorizing AEP Ohio to recover an above-market charge of $188.88/MW-day for capacity and reinstate the previous RPM market-based capacity price.

Respectfully submitted,



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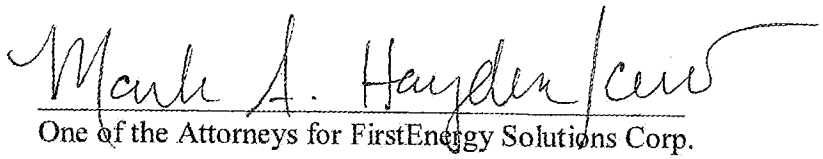
CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing *Third Merit Brief of Appellant FirstEnergy Solutions Corp.* was served this 23rd day of October, 2013, via first-class U.S. mail, postage prepaid, upon the parties below.



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