Electricity Post 2008

A Common Sense Blueprint for Ohio

Executive Summary

Ohio is one of more than 20 states that adopted electric restructuring legislation with high expectations of results that include lower prices, better service and innovation. Actual results are vastly different than the expectations, and the states that adopted restructuring legislation are scrambling to effectively address the problems that seem to get more difficult by the day.

To its credit, the PUCO saw this problem coming and adopted rate stabilization plans to gain some time and experience. As things presently stand, most of the rate stabilization plans are scheduled to end on December 31, 2008 and utilities are filing applications at the PUCO so that they can establish new prices effective January 1, 2009. FirstEnergy ("FE") has filed proposals with the PUCO that will significantly increase electric prices effective January 1, 2009. One of the proposals includes an auction process to establish prices for generation supply.

Ohio's leaders are well aware of the electricity challenges that need to be addressed. But, there is no Ohio process or plan currently in place to systematically address these challenges. This condition persists despite the pleas from retail customer representatives. Fear, uncertainty and ambiguity are negatively affecting the ability of businesses to maintain and expand operations in Ohio and the ability of utilities to raise and invest capital in the long-lived assets that dominate the electric grid. Energy summits and periodic meetings between state officials and stakeholders have shown little or no return.

The rate shock clock is ticking in Ohio. We have urged Ohio's leaders to consider how the worthwhile objectives of electric restructuring might be better accomplished through changes to Ohio's electric restructuring law. We would have rather approached Ohio's leaders with a consensus proposal for changes to Ohio's law and have devoted substantial efforts over a period of years to consensus building as a result of this preference. A consensus has not, however, emerged and the time for action is getting shorter by the day. The painful consequences of inaction are readily identifiable by examining the conditions in states like Illinois, Pennsylvania and Maryland.

For the reasons explained below, we recommend that Ohio take the actions outlined below. None of the options available to Ohio should be expected to guarantee lower electric prices. But with some hard work and common sense, Ohio can ensure that its citizens have access to reliable electric supplies at reasonable prices.

Summary of Recommendations

1. We recommend that Ohio proactively use the tools available under existing law to ensure customers have access to reliable electric service at reasonable prices.

2. We recommend that the General Assembly repeal the statutory declaration that generation service is a competitive service for purposes of giving Ohio better options to affect the price of electricity. This action would align Ohio law with reality and position Ohio to better control electric price and service outcomes for the benefit of the public interest.

3. We recommend that Sec. 4928.17(E) be repealed and that any unused generation asset transfer permission that the PUCO may have granted under federal law be declared void as contrary to the public interest in order to manage the risks presented by claims and schemes like those of Monongahela Power.

4. We recommend that the PUCO use its authority to conduct a critical review of the RTO selections made by FE, AEP, DP&L and CG&E. We believe this review will quickly disclose that the RTO selections do not satisfy Ohio's RTO criteria or work in favor of Ohio's electric price and service quality objectives. If so, we recommend that the PUCO find that the RTO selections made by Ohio's utilities do not meet SB 3's requirements, do not work in favor of Ohio's electricity objectives, and that the PUCO preclude recovery of any RTO costs incurred by such utilities until such time as the utilities demonstrate the benefits derived by consumers exceed the costs.

5. We recommend that Ohio restore or confirm the vitality of "special arrangements" as an economic development and retention tool.

6. We recommend that Ohio consider establishing an Energy Security Authority ("ESA") and enable the ESA to facilitate "least cost" capital formation for demand and supply side options that advance Ohio's electricity objectives.

Context

In 1999, Ohio adopted electric restructuring legislation (Amended Substitute Senate Bill 3 – "SB 3") like 23 other states did before Ohio. The enactment of this legislation occurred after seven years of lively discussions with issues periodically framed by proposed bills.

SB 3 begins with a clear statement of objectives to guide the PUCO's implementation. Among other things, the General Assembly (*via* Sec. 4929.02) directed the PUCO to "…ensure the availability to consumers of adequate, reliable, safe, efficient, nondiscriminatory and reasonably priced retail electric service", "ensure retail electric service consumers protection against unreasonable sales practices, market deficiencies and market power", and "facilitate the state's effectiveness in the global economy".

SB 3 assumed that effective competition would – over time – better serve the public interest in reasonable electric prices and reliable service than traditional regulation.

SB 3 assumed that the federal government would enable effective and dynamically efficient competition in the wholesale electric market (a necessary condition for competition in the retail market).

SB 3 assumed that each electric utility would participate in a "regional transmission entity" meeting specified criteria and it provided the PUCO with authority to supervise such participation (Sec. 4928.12) to advance Ohio's electric objectives.

The PUCO deferred addressing regional transmission entity issues in 2000 and has not completed this work.

SB 3 assumed that effective competition would lower prices relative to 1999 levels and billions of dollars were paid to Ohio electric utilities – all of them – as "stranded" or "transition" costs based on estimates of the future electric prices that would be produced by effective competition. There was no auction to determine the "market value" of the assets. In fact, some Ohio utilities discouraged the use of auctions to establish market-based "stranded" results.

Ohio established the transition cost recovery opportunity to ensure that Ohio's electric utilities would not be hampered by legacy costs as they entered the competitive market. Ohio also reformed property and gross receipts taxes that applied to electric utilities to better position the utilities to compete in a competitive market. Through the Ohio Air Quality Development Authority ("OAQDA"), Ohio has also continued to assist electric utilities raise relatively low cost capital to fund investment in environmental-related measures and to better position electric utilities to compete.

The measures inserted in SB 3 for the benefit of electric utilities have worked superbly to permit utilities to enhance their competitive position and promote their financial health.

Based on the expectation of lower prices, SB 3 provided residential customers a rate reduction (effective 1-1-01) equal to 5% of the unbundled generation component. The PUCO was given the authority to adjust this rate reduction if the PUCO determined that it was impeding market development. The PUCO did not adjust the residential rate reduction.

Based on the expectation that generation service would be subject to effective competition (the invisible hand of competition would produce reasonable prices, high quality service and reward innovation), the General Assembly declared generation service to be a "competitive" service (whether it is or not) and removed specified aspects of the supervisory/regulatory powers of the PUCO and municipalities.

In early 2002, it became apparent that the critical assumptions regarding the timing and scope of effective competition in the electric industry were excessively optimistic. The Western energy crisis and escapades of Enron (among others) put a stop to any further electric restructuring at the state level and left those states that had already implemented electric restructuring legislation to consider how to manage risks not anticipated when their respective state laws were enacted. In some cases, such state restructuring laws required divestiture of generating assets thereby erecting potential legal barriers or other obstacles to reestablishing state control over prices and service requirements.

SB 3 established price caps that applied during a "market development period" ending no later than 12-31-05. These price caps coupled with PUCO-approved accounting conventions somewhat peculiar to regulated utilities helped utilities recover "stranded" costs.

SB 3 provided utilities with authority to divest generation assets without securing approval by the PUCO. In some cases, the PUCO's consent to transfer generation assets was nonetheless required by federal law and the PUCO provided such consent to FE (Ohio Edison, Toledo Edison and Cleveland Electric Illuminating), American Electric Power ("AEP" – Ohio Power and Columbus Southern Power) and Cincinnati Gas & Electric ("CG&E"). In some cases, customer representatives urged the Commission to not grant such authority as a result of the early indications that the expectations about development of a competitive market were not matching up with real world conditions and because the transfer of generating assets might reduce Ohio's ultimate ability to influence price and service quality outcomes. The generating asset transfer consent provided by the PUCO in the case of AEP and CG&E has not been used by the utilities. All of Ohio's investor-owned electric utilities continue to own or control at least some generating assets.

SB 3 continued to obligate electric utilities to supply "firm" electricity to customers not supplied by competitive suppliers. SB 3 incorporated this "provider of last resort" obligation in a "standard service offer" requirement.

Under SB 3, any competitive services included in the standard service offer or "SSO" after the market development period (or 12-31-05) are to be priced by the PUCO using a "market-based" standard while non-competitive services continue to be priced in accordance with traditional, cost-plus regulation.

The term "market-based" is not defined by Ohio law or PUCO regulations. Ohio's electricity objectives require the PUCO to ensure that prices are reasonable.

The term "firm" is not defined by Ohio law or PUCO regulations. Ohio's electricity objectives require the PUCO to ensure that customers receive an adequate and reliable supply.

Whether traditional regulation or "market-based" pricing applies, electric utilities cannot change prices for electricity until they file an application with the PUCO (under Sec. 4909.18) and the PUCO approves the new price.

If the PUCO determines that a utility pricing proposal filed under Sec. 4909.18 may be unjust or unreasonable, it must subject the proposal to an investigation and a hearing process and the utility must demonstrate that its proposal is reasonable before the PUCO can approve the proposal.

As a result of the slower than expected pace of market development, in 2003 the PUCO encouraged electric utilities to file rate stabilization plans. All but one Ohio electric utility (Monongahela Power) filed rate stabilization plans. Almost all of the rate stabilization plans have resulted in significant increases in electric prices since 1-1-06. Notwithstanding the resulting rate increases, the PUCO's rate stabilization plan approach has received support from most customer representatives, including IEU-Ohio.

The current rate stabilizations plans are scheduled to end on 12-31-08 except in the case of Dayton Power & Light (12-31-10). As indicated above, the PUCO must approve replacement prices before they can be used by utilities to bill customers. Current rates and charges remain in effect until the PUCO approves replacement rates and charges.

In one of the many Monongahela Power regulatory proceedings, the PUCO rejected IEU-Ohio's request that the PUCO direct Monongahela Power to file a rate stabilization plan. This PUCO ruling was accompanied by some language that indicated that the PUCO may not have the authority to require a utility to adopt a rate stabilization plan under SB 3.

The PUCO was also somewhat passive during all the rate stabilization proceedings as the utilities threatened to "go to market" if stakeholders and the PUCO did not accept the utility's rate stabilization plan demands. As a result of the PUCO's response to these "go-to-market" threats, customer representatives found themselves with little leverage to achieve outcomes that were materially different than those associated with the demands of utilities.

The PUCO's somewhat passive response to the utilities' go-to-market threats may have resulted from the PUCO's hope that a real competitive market would report for public service if given a bit more time (by the time the rate stabilization plans ended). Whatever the PUCO's reasons, it is now clear that hoping for improvement and counting on being lucky are not good strategies if Ohio wants to accomplish its electric objectives.

Since 2002, IEU-Ohio has actively supported legislative action to ensure that the PUCO's prudent efforts to respect and balance the interests of utility owners and customers are not undone by gaps in current law or stakeholders unwilling to let go of their litigation positions regardless of circumstances or conditions. IEU-Ohio has also urged the PUCO to proactively use the full range of its authority to produce reasonable rates and reliable service. Utilities have resisted legislation introduced for this purpose asserting that it would take Ohio down a "slippery slope". The PUCO has been agnostic about such legislation at times suggesting that it had things under control.

In October 2003, a joint Ohio House committee expressed support for the PUCO's rate stabilization plan approach, made it clear that Ohio expected effective competition to be in place prior to dumping customers into a "market" and encouraged the PUCO to bring recommendations to the General Assembly if the PUCO believed it needed additional authority to discharge its public interest duties.[1]

In 2005, the PUCO approved a rate stabilization plan for AEP that included a requirement for the PUCO to initiate a process by which stakeholders could recommend and the PUCO could consider the regulatory structure that might be established to better meet the needs of utilities and customers. The PUCO has not initiated this process and has announced no plans to do so.

In May 2007, Governor Strickland issued a statement and "first principles" which included the following text:

> In 1999, Ohio lawmakers created a plan to restructure our electric utility industry. Supporters made some assumptions at the time: they believed Ohio could deregulate electric generation because a competitive market would emerge; many believed that electric rates would go down; they believed electricity was just like other industries that had been deregulated.
>
> But electricity, it turns out, is different. It is of such profound importance to our way of life that electricity deregulation has had a more than checkered past and maintains an uncertain future.
>
> Competitive markets simply have not developed. And lower electric rates were probably not a realistic expectation.

[1] On October 15, 2003, the Select Committee to Study Ohio's Energy Policy issued a report to the House of Representatives. The Committee was charged with the task of making sure that as the world changes, Ohioans will have adequate supplies of safe, reliable and clean energy supplies of energy now and in the future. The report was assembled based on the input the Committee received during 11 hearings between April 2002 and January 2003. The report included a discussion about early indications that Ohio's electric restructuring expectations were not in alignment with actual results. At page 3 of the report, the Committee stated:

> As Ohio treaded into uncharted waters by being one of the first states to deregulate its electric utility industry, the General Assembly knew that regulation and oversight by the PUCO would be necessary to achieve a competitive market. The legislature gave the PUCO a tremendous amount of supervision and management authority in SB 3, and it continues to monitor the market as we move through the transition periods. For example, to give competition more time to develop, the PUCO approved an extension of the transition period for Dayton Power & Light. Consumer advocates, regulatory officials and industry representatives worked together to craft a new plan, agreed to by the parties, to continue the framework of a competitive market while allowing some protection to customers. **The members encourage the PUCO to continue to take the necessary steps, whether by rule or a request for legislation, to ensure that a healthy competitive market is in place before full competition begins.** Ohio has been a model to the rest of the county regarding its innovative and vanguard approach to the electric utility industry. By continuing to design good public policy to shape the industry, Ohio can remain a prosperous, growing state through the 21st Century.

> In fact, in other states deregulation has brought with it significant *increases* in utility rates. According to the U.S. Department of Energy, customers in states with deregulated electricity paid 30 percent more last year than customers in regulated states.
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> However, we cannot go back to the "good old days" – of cost-of-service regulation – we cannot put the Genie back in the bottle. So how do we move forward? One approach to the unfolding regulation situation we face is to opt for a band-aid solution that buys time and avoids, at least for a while, the worst of the rate increases in the hope that in a couple of years the electricity market will have changed and we can revisit the problem.
>
> I do not believe we have the luxury of that approach. The future of energy will not wait for us to make a decision. Waiting would jeopardize our economy, constrain our capacity to generate energy, threaten our environment, reduce our ability to improve efficiency, and limit our capacity to lead the nation in the production of advanced energy technology.
>
> So I stand ready to work with the legislature, with industry, with the utilities, and with advocates, to shape the future of the electricity market in Ohio.

The experience in states (like Illinois, Maryland and Pennsylvania) that have resorted to auctions or so-called "competitive bidding procedures" to establish electric generation supply prices demonstrates that rate shock, debilitating uncertainty, extraordinary volatility, polarizing politics and injury to the economy await Ohio and other states that do not proactively address the profound mismatch between expectations about electric restructuring and actual results. Appeals that FERC do something to "fix" the problems have proven to be fruitless just as they were when an energy crisis crippled the Western part of the United States. Because Ohio's economy is relatively energy-intensive, Ohio's economy and its citizens are disproportionately at risk.

The chaos and dysfunction observable in other states that have resorted to auctions to establish retail electric prices negatively affect customers and utilities. The capital formation and investment that is required to maintain and expand the long-lived assets that compose the electric industry's infrastructure and provide the quantity/quality of service needed by customers suffer as the regulatory structure and public policy take on ambiguous or disorienting significance.

There is **nothing** in SB 3 that requires an auction or competitive bidding process to be used to establish a "market-based" price for the SSO. There was no auction conducted to measure "stranded costs" and some utilities claimed that an auction process should not be employed for such purpose. An auction for generation supply that occurs in a highly concentrated or dysfunctional market is an accident waiting to happen and the accident has already happened in several states with predictably disastrous results.

FE has filed an auction proposal with the PUCO to establish SSO prices effective 1-1-09. FE has also filed an application to increase distribution prices. If FE's distribution rate increase is approved as proposed and the auction results for FE's Pennsylvania utility are assumed as being the results in Ohio, some all-electric residential customers served by the Cleveland Electric Illuminating Company will see monthly bill increases in excess of 100% effective 1-1-09 (going from $237 to $483 per month).[2] The impact for large manufacturers will be similar or worse (particularly for the energy intensive manufacturers historically served under "special arrangements").

While rate shock is the likely result of any auction overlaid on an immature and dysfunctional wholesale market, some stakeholders continue to be auction-friendly. The Office of Consumers' Counsel ("OCC") has described FE's auction proposal as "a positive step in the right direction".[3]

Despite clear statements by Ohio's leaders that indicate they are aware of the electric restructuring problems and the need to promptly act to actively manage the risks that such problems impose, Ohio's rate shock clock continues to tick. No consensus-based recommendation has been sought or obtained and there is nothing happening in Ohio to commence the serious discussions that must take place as part of any legislative process.

In this context, IEU-Ohio offers the following recommendations. The recommendations include two primary prongs or components that focus on Ohio's electric price challenges. One prong identifies tools that the Ohio General Assembly gave the PUCO in SB 3 or elsewhere; tools that could be used by the PUCO to better meet the needs of Ohio's electric consumers and suppliers. The other prong identifies relatively simple modifications to SB 3 that, if adopted and applied in conjunction with the PUCO's existing tools, would provide Ohio with greater ability to address, in a balanced way, issues that affect the price and availability of electric service within Ohio. Other aspects of the recommendations consider structures that may allow Ohio to better integrate demand and supply side resources to achieve reliability and price objectives and to address Ohio's economic development and retention challenges. There is no magic bullet or risk free path forward. Further delay will only make things harder and reduce the options available to Ohio's leaders.

As Ohio's leaders consider the recommendations and components, IEU-Ohio urges Ohio's leaders to not frame issues as though they require a choice between "regulation", "competition" or some "hybrid". We ask Ohio's leaders to select the means by which the important issues must be resolved based on the ability of the means to achieve outcomes that properly balance the interests of customers and utility owners. Outcomes that subject Ohio customers to the worst of both worlds are not acceptable regardless of the means

[2] FE's proposal includes a provision that is designed to limit the total bill increase for all residential customers to 15%. The cost of this 15% cap is deferred for future recovery so the 15% limit is eventually paid for by customers. It is not clear how this limit might affect the rate shock experienced by specific residential rate schedules such as the rate schedules that currently apply to all-electric residential customers.

[3] Cleveland Plain Dealer, July 11, 2007, *PUCO Would Approve Final Rates*.

chosen to get there. It is the end result – not the means – that will dictate the health of Ohio and its status in the global economy.

Blueprint Page 1

More Can Be Done Under Current Law IF the PUCO Uses Tools It Was Given By the General Assembly

The PUCO has tools under existing law to address price and reliability objectives of customers. These tools were not designed to specifically deal with current conditions because the current conditions were not anticipated at the time the legislation was developed. But, absent legislative action, they are the tools available to the PUCO and Ohio and they need to be applied to the work ahead. The General Assembly directed the PUCO to use these tools to accomplish the objectives set out in Section 4928.02, Ohio Revised Code. The PUCO has thus far chosen to not use all the tools at its disposal to secure balanced outcomes and ensure that go-to-market threats do not trump the public interest.

The direction that the PUCO use the tools it has been given to ensure that issues affecting the price and availability of electricity are resolved quickly and in a balanced way[4] should be reinforced. It should be accompanied by a renewed request that the PUCO promptly identify any gaps in its current authority that may preclude it from accomplishing these objectives or make the work unreasonably difficult or expensive.

Some of the PUCO's Tools

- State Policy (4928.02)
- Standard Service Offer ("SSO") must be reasonable (4909.18)
- Market-based price can't be effective without PUCO approval
- "Market-based" is not defined by the law – auctions are not the only way to estimate "market-based" prices
- "Firm" is not defined by the law
- Review/approval of regional transmission organization ("RTO") plans
- Review/approval of rate adjustments related to FERC transmission prices
- Review/approval of security issuances
- Authority related to "non-competitive" services (ancillary, distribution – price and service quality)
- Authority related to corporate separation
- Authority related to accounting (depreciation, deferral accounting)
- Adjustment of "transition cost" allowances
- Monitoring, reporting and recommendations for legislative action
- Protests of applications to secure market-based rate authority from FERC
- Approval of any termination of "special arrangements"

[4] See footnote 1.

The State of Ohio has other tools at its disposal that can be applied to better ensure that issues affecting the price and availability of electricity are resolved quickly and in a balanced way. These tools involve the application of the taxing authority of Ohio and consideration of the rights and privileges given to utilities in light of the utilities' respect (or lack thereof) for Ohio's electric price and service quality objectives.[5]

Tools possessed by the PUCO or more broadly by the State of Ohio are of little value if they are left in the tool box. If utilities threaten Ohio with unreasonable demands in response to the actions Ohio has taken to ensure that these utilities have a good opportunity to maintain and improve their financial condition, then the risks presented by these threats must be proactively managed by Ohio.

We recommend that Ohio proactively use the tools available under existing law to ensure customers have access to reliable electric service at reasonable prices.

Blueprint Page 2

Aligning Ohio Law with Reality and Positioning Ohio to Better Control Electric Price and Service Quality Outcomes for the Benefit of the Public Interest

SB 3 unbundled electric services along functional lines (generation, transmission ancillary and distribution) and created two classifications ("competitive" and noncompetitive") of unbundled services. Depending on the classification, the PUCO may be obligated to apply different pricing rules. If a service is competitive and it is part of the service bundle that forms the standard service offer or SSO, Sec. 4928.14 indicates that the PUCO will use a market-based pricing standard applied through the process required by Sec. 4909.18.

In some cases (metering, billing and ancillary services, for example), SB 3 gave the PUCO authority to declare a service competitive using statutory criteria and to reverse such a declaration in the event circumstances changed. Until such time as service is declared to be competitive, the price for the service continued to be based on the form of cost-based regulation that applied prior to the adoption of SB 3.

Based on the expectations that existed when SB 3 was moving through the General Assembly, it was assumed that generation service would be a competitive service. But SB 3 treated generation service differently than other unbundled services. Rather than leaving it up to the PUCO to determine if generation service would actually become a competitive service, SB 3 declared generation service to be competitive. In Section 4928.06, SB 3 required the PUCO to monitor what was actually going on with generation service and to provide periodic reports to the General Assembly along with any recommendations for legislation as a result of the PUCO's monitoring function.

[5] For example, OAQDA has provided utilities with access to relatively attractive debt capital and Ohio law has provided the utilities with tax-related benefits for equipment and facilities financed with the assistance of the OAQDA. Thus, Ohio has taken action to lower the costs incurred by electric utilities to provide service. If the benefit of this privilege is not available to Ohio electric customers because the utilities are using it to increase their auction-based price profits, Ohio may want to examine the nature and scope of requirements that must be met to gain access to the benefits available through OAQDA.

Because SB 3 declares generation service to be a competitive service (whether it is or not) as a matter of law, Sec. 4928.14 also indicates that the PUCO should use a market-based pricing standard to establish the price for the generation service component included in the SSO. But for this competitive service declaration in SB 3, the generation service component included in the SSO would be subject to pricing in accordance with Ohio's traditional cost-based standard.

Getting back to the "good old days" is obviously more complicated than a simple change to some words included in SB 3. But, eliminating the use of a market-based pricing standard for purposes of establishing prices for generation service is a relatively easy change to make given the structure of SB 3. If the statutory declaration that generation service is competitive is repealed, generation service would be classified as a noncompetitive service and the market-based pricing standard would not apply until such time as the PUCO might determine that generation service met the competitive service criteria.

We recommend that the General Assembly repeal the statutory declaration that generation service is a competitive service for purposes of giving Ohio better options to affect the price of electricity. This action would align Ohio law with reality and position Ohio to better control electric price and service outcomes for the benefit of the public interest.

Blueprint Page 3

Apply the Lessons from the Monongahela Power Experience

The litigation that occurred as a result of the PUCO's efforts to resist Monongahela Power's rate-shock-loaded auction proposals included a utility claim that the PUCO was obligated, under federal law, to permit Monongahela Power to pass through to its Ohio customers its purchased power costs incurred to satisfy its SSO obligation. The foundation for this claim is provided (in very general terms) by our federalist system of government and relies on preemption attached to FERC grants of market-based rate authority for wholesale sales of electricity. This pricing authority permits wholesale sales of electricity to be priced by the seller as opposed to being priced by the regulator in accordance with a cost-based formula.[6] Monongahela Power claimed (wrongly) that it had transferred its generation

[6] The courts have permitted FERC to institute flexible pricing so long as the overall regulatory scheme is premised on the existence of an "empirically proven" competitive market and protects against the exercise of market power. Where FERC determines that such a competitive market exists and that an applicant lacks market power, FERC may depart from a strictly cost-based determination of rates, and approve rates reached as the result of competition. FERC's authority to approve market-based rates has been approved by the courts when a competitive market exists and FERC has demonstrated that there is sufficient protection against the exercise of market power. *Elizabethtown Gas Co. v. FERC*, 10 F.3d 866, 870-71 (D.C. 1993); *Louisiana Energy and Power Authority v FERC*, 141 F.3d 364, 369-370 (D.C. Cir. 1998); *Interstate Natural Gas Association of America V. FERC*, 285 F.3d 18, 31-34 ((D.C. Cir.) 2002); *California ex rel. Lockyer v. FERC*, 383 F.3d 1006, 1013-1014 (9th Cir. 2004). While the court cases indicate that FERC has an obligation to ensure that markets are capable of ensuring just and reasonable rates prior to allowing the seller to use market pricing authority, FERC's grants of market pricing authority indicate little or no interest in fulfilling this obligation. FERC's imprudent grants of market pricing authority and inattention to the rate shock and unreliable service consequences that have plagued electric consumers Nationwide are primary contributors to the problems that have dominated efforts to enable effective competition in the electric industry.

assets to an unregulated affiliate and that it had to purchase electricity at market-based prices in the wholesale market to satisfy its retail service obligations. It then claimed that federal preemption required the Ohio and the PUCO to authorize Monongahela Power to recover the purchased power costs from its Ohio customers. In other words, Monongahela Power attempted to use federal law as a tool to prevent Ohio from affecting its opportunity to dramatically increase electric prices in Ohio through a scheme that featured:

- A transfer of generating assets to an unregulated affiliate at "net book value";
- A wholesale sale of electricity from the unregulated affiliate to Monongahela Power at market-based prices;
- Monongahela Power's calculation of its cost of generation supply based on wholesale market prices; and
- A claim of federal preemption that was designed to obligate Ohio to permit Monongahela to automatically pass on the cost of its wholesale purchased power calculated based on "market prices" set by its unregulated affiliate.

The Ohio experience with Monongahela Power is not unique. Similar claims have been advanced or threatened in Ohio and other states and their potential must be considered as Ohio evaluates options to give it better control over electric price and service quality outcomes.

As indicated above, SB 3 provided utilities with unilateral authority to divest generating assets without PUCO approval subject to certain limitations. Notwithstanding SB 3, federal law requires PUCO consent in the case of certain types of generation asset transfers. Under this federal law, the PUCO has granted permission for generation asset transfers to AEP, CG&E and FE and FE has exercised such authority to push control over certain generating assets to an unregulated affiliate. It is reasonable to expect that AEP and CG&E may also exercise such authority.

We recommend that Sec. 4928.17(E) be repealed and that any unused generation asset transfer permission that the PUCO may have granted under federal law be declared void as contrary to the public interest in order to manage the risks presented by claims and schemes like those of Monongahela Power

Blueprint Page 4

Stop Funding the Rate Shock Proposals of FERC and its RTO Agents

As indicated above, the electric price and service quality problems with which Ohio must contend are being made worse by FERC's fundamental inattentiveness to its public service obligations.

In 1998, the Midwest became the first poster child for electric price spikes and reliability problems. After a quick investigation, FERC concluded that the Midwest problems were an aberration and that everything would be fine once its plan for regional transmission organizations was implemented.

Next the West laid claim to being the rate shock and blackout capital of the United States while FERC reported that it could find no indication of irregularities and FERC's Chairman attempted to make California's Governor responsible for the obvious problems. It was not until some municipal utilities released tape recordings of marketers' phone conversations about the size and scope of their market manipulations that FERC was forced to let go if its denial defense. But FERC was slow to awaken and, in the meantime, huge amounts of wealth had been transferred through sellers' abuse and manipulation of FERC-granted market pricing authority.

Then attention shifted back to the East. On August 14, 2003, the largest blackout in the history of the United States brought the economies of several states and portions of Canada to a standstill. While FERC had created RTOs to manage electric reliability in real time and prevent blackouts like the one on August 14, 2003, FERC's RTO agent having responsibility for the area where the blackout originated did not have its reliability management system working on August 14, 2003.

In recent months, FERC has resisted suggestions that it proactively address claims made by an independent market monitor that an RTO had actively prevented the market monitor from disclosing market power problems or conditions that may have negatively affected customers. Only after substantial complaints by state regulatory authorities did FERC initiate a formal process.

For more than a decade, FERC has been passive and slow to respond to reliability and price concerns raised by customers and utilities. Rather than addressing stakeholder concerns about the unsavory results of FERC's efforts to enable effective competition in the electric industry, FERC has blamed states, chanted a "stay the course" mantra and scheduled meaningless technical conferences.

The opportunity for FERC to create and expand the messes that trickle down to state regulators has increased over time as a result of FERC's efforts to direct implementation of even more complicated market structures known generally as the "Day 2" markets. "Day 1" structures mostly focus on management of the grid to enhance real time reliability and establishing a settlement procedure for imbalances between supply and demand. The Day 2 structures also provide a more friendly platform for utilities that see value from the type of scheme adopted by Monongahela Power. The RTOs that divide Ohio (MISO and PJM) are both pushing the Day 2 envelope and FERC has not been moved to let go of its rubber stamp by the substantive protests of stakeholders including state regulators.

SB 3 gave the PUCO authority to oversee the RTO selections of Ohio transmission owners and provided the PUCO with objectives by which the PUCO should evaluate the selections. The PUCO has not used this authority.

We recommend that the PUCO use the authority delegated by SB 3 to conduct a critical review of the RTO selections made by FE, AEP, DP&L and CG&E. We believe this review will quickly disclose that the RTO selections do not satisfy Ohio's RTO

criteria or work in favor of Ohio's electric price and service quality objectives. If so, we recommend that the PUCO find that the RTO selections made by Ohio's utilities do not meet SB 3's requirements, do not work in favor of Ohio's electricity objectives, and that the PUCO preclude recovery of any RTO costs incurred by such utilities until such time as the utilities demonstrate the benefits derived by consumers exceed the costs.

The PUCO can and must do more to insulate Ohio's electric customers from the pain and suffering that FERC and its RTO agents are creating through the exercise (or lack thereof) of their discretionary powers over the price and quality of wholesale electric supply.

Blueprint Page 5

Restore or Confirm the Viability of "Special Arrangements"

Ohio has along been the home of many energy-intensive manufacturers that compete globally for their customers. Some of these energy-intensive customers see annual electric bill changes that are in excess of $1,000,000 if their electric price per kWh changes by a mere tenth of a cent.

For decades, Ohio encouraged the use of "special arrangements" to meet the customized service quality and price needs of these larger customers. These arrangements established prices and service terms and conditions and, once approved by the PUCO under Sec. 4905.31, were often used to help Ohio address economic development and retention objectives. Special arrangements were and are not unique to the electric industry; they are also used by gas, water and communications utilities. The enabling authority for "special arrangements" (Sec. 4905.31) was not repealed or altered by SB 3.

With Ohio's rate shock clock ticking, some of Ohio's manufacturers have approached electric utilities with a request for a "special arrangement" that would bring needed certainty and predictability to electric costs. Ohio's electric utilities often respond that SB 3 made "special arrangements" illegal or that the PUCO will not let the utilities enter into "special arrangements". Given Ohio's economic development and retention challenges, these utility responses to customers' requests are sending a chilling message to businesses that want to retain or expand their Ohio operations.

We recommend that Ohio restore or confirm the viability of "special arrangements" as an economic development and retention tool.

As has been done in the past, the viability of this tool will depend on the structure and quality of the means by which Ohio distributes the costs and benefits of these special arrangements.

The historical process by which special arrangements have been approved and reviewed may need to be modified to reflect the increased sensitivity to a public release of energy

pricing information and to manage the risks that some parties may use the litigation process to delay, block or make more cumbersome the use of a special arrangement tool.

As things presently stand, some utilities have been and are telling special arrangement customers that their contracts will end soon and they will be placed on a rate schedule that will almost certainly produce rate shock. Ohio must address this problem now either through efforts to ensure that replacement contracts are put in place or by directing that existing contracts continue until a suitable replacement is established. Under Sec. 4905.31, special arrangements may not be terminated without the approval of the PUCO.

As Ohio considers energy price actions that could be taken to enhance economic development and retention efforts, it ought to also consider modifications to the kWh tax and the pricing structure for the Universal Service Fund ("USF") used to help certain customers pay their utility bills. Taxes or other charges that are levied on large energy-intensive customers based on kWh usage tend to tilt the funding responsibility to these customers and can negatively affect their competitiveness.

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Least Cost Planning and Implementation

As discussed above, the electricity challenges that Ohio must address include issues about how to plan and pay for the capital investment required to maintain and expand the ability of the electric system to provide reliable service. Increasingly, these challenges are tied to questions about what environmental laws and regulations will look like as we move through the 21st Century.

Some utilities seem to want to seek advantages by proposing responses to these challenges that include "incentives", luxury profits and transfers of financial/business risk to customers or a transformation of customers into involuntary investors. AEP's Ohio integrated gasification combined cycle ("IGCC") proposal is one example of such a proposal which promises a very high price, no accountability for useful performance and great potential for Ohio carrying costs while the benefits are taken elsewhere. AEP's proposal also resulted in customers getting the worst of both worlds; high "market prices" for relatively low-cost generating plants and guaranteed cost recovery for very expensive, hypothetical generating plants.

Under the current FERC vision and RTO structure, the benefit of the output of an electric generating plant is not preserved for the customers that pay for the plant. This vision and structure is also causing Ohio customers to pick up costs for transmission investment that will be remote from Ohio and be used to export Ohio produced electricity to other states and regions. Electricity flows in interstate commerce and the specific state location of a generating plant has almost nothing to do with the geographical region affected by the output of a new electric generating plant. The flow of electricity and the reliability of the electric grid are controlled by the law of physics – not the law of Ohio.

If Ohio's regulators and policy makers determine that Ohio customers must assume the role of investors or make non-bypassable payments to rationalize the capital investment that will likely be required over the next two decades, it is incumbent upon Ohio's leaders to ensure that customers get the best bang for their buck. Ohio's leaders must also make sure that customer investments are protected by performance accountability that will best ensure that customers get the necessary return on their investment.

We recommend that Ohio consider establishing an Energy Security Authority ("ESA") and enable the ESA to facilitate "least cost" capital formation for demand and supply side options that advance Ohio's electricity objectives (Sec. 4928.02).

The demand side options should focus on cost-effective strategies for reducing Ohio's energy intensity (amount of energy required to produce a unit of state domestic product) and improving reliability and service quality that often yield environmental benefits. The ESA should have sufficient authority to provide a conduit for public-private action to address the statewide needs of customers of coops, munis and investor-owned utilities and to integrate demand and supply side options.