BEFORE

THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application of Ohio Edison Company, Cleveland Electric Illuminating Company and Toledo Edison Company for Authority to Continue and Modify Certain Regulatory Practices and Procedures, for Tariff Approvals and to Establish Rates and Other Charges Including Regulatory Transition Charges Following the Market-Development Period	**)**	**Case No. 03-2144-EL-ATA**

DIRECT TESTIMONY OF

PAUL CHERNICK

ON BEHALF OF

GREEN MOUNTAIN ENERGY COMPANY

Resource Insight, Inc.

FEBRUARY 6, 2004

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I. Identification and Qualifications

Q: Mr. Chernick, please state your name, occupation and business address.

A: I am Paul L. Chernick. I am the president of Resource Insight, Inc., 347 Broadway, Cambridge, Massachusetts.

Q: Summarize your professional education and experience.

A: I received an SB degree from the Massachusetts Institute of Technology in June 1974 from the Civil Engineering Department, and an SM degree from the Massachusetts Institute of Technology in February 1978 in technology and policy. I have been elected to membership in the civil engineering honorary society Chi Epsilon, and the engineering honor society Tau Beta Pi, and to associate membership in the research honorary society Sigma Xi.

I was a utility analyst for the Massachusetts Attorney General for more than three years, and was involved in numerous aspects of utility rate design, costing, load forecasting, and the evaluation of power supply options. Since 1981, I have been a consultant in utility regulation and planning, first as a research associate at Analysis and Inference, after 1986 as president of PLC, Inc., and in my current position at Resource Insight. In these capacities, I have advised a variety of clients on utility matters.

My work has considered, among other things, the cost-effectiveness of prospective new generation plants and transmission lines, retrospective review of generation-planning decisions, ratemaking for plant under construction, ratemaking for excess and/or uneconomical plant entering service, conservation program design, cost recovery for utility efficiency programs, the valuation of environmental externalities from energy production and use, allocation of costs of service between rate classes and jurisdictions, design of retail and wholesale

rates, and performance-based ratemaking and cost recovery in restructured gas and electric industries. My professional qualifications are further summarized in Attachment PLC-1.

Q: Have you testified previously in utility proceedings?

A: Yes. I have testified approximately one hundred and ninety times on utility issues before various regulatory, legislative, and judicial bodies, including the Arizona Commerce Commission, Connecticut Department of Public Utility Control, District of Columbia Public Service Commission, Florida Public Service Commission, Maryland Public Service Commission, Massachusetts Department of Public Utilities, Massachusetts Energy Facilities Siting Council, Michigan Public Service Commission, Minnesota Public Utilities Commission, Mississippi Public Service Commission, New Mexico Public Service Commission, New Orleans City Council, New York Public Service Commission, North Carolina Utilities Commission, Public Utilities Commission of Ohio, Pennsylvania Public Utilities Commission, Rhode Island Public Utilities Commission, South Carolina Public Service Commission, Texas Public Utilities Commission, Utah Public Service Commission, Vermont Public Service Board, Washington Utilities and Transportation Commission, West Virginia Public Service Commission, Federal Energy Regulatory Commission, and the Atomic Safety and Licensing Board of the U.S. Nuclear Regulatory Commission.

Q: Have you testified previously before the Public Utilities Commission of Ohio (the Commission or PUCO)?

A: Yes. I testified on Cincinnati Gas and Electric's resource planning in PUCO Cases No. 91-635-EL-FOR, 92-312-EL-FOR, and 92-1172-EL-ECP on behalf of the City of Cincinnati, and in PUCO Case No. 95-203-EL-FOR on behalf of the Campaign for an Energy-Efficient Ohio.

Q: Have you been involved in other activities regarding utility planning and regulation in Ohio?

A: Yes. At the request of the State of Ohio Office of Energy Efficiency, I made presentations on "DSM Cost Recovery and Rate Impacts" and "Cost-Effectiveness Analysis" as part of the Energy Efficiency Office's week-long program "Effective DSM Collaborative Processes" in August 1993; and on "The Economic and Environmental Benefits of Gas IRP: FERC 636 and Beyond" as part of the Office's seminar, "Gas Utility Integrated Resource Planning," April 1994.

Q: Are you the author of any publications on utility planning and ratemaking issues?

A: Yes. I am the author of publications on rate design, cost allocation, cost recovery, cost-benefit analysis, and other ratemaking issues. Several of my recent papers and reports deal with issues in electric and gas industry restructuring, including integrated resource planning and performance-based ratemaking. These are listed in my resume.

II. Introduction and Summary

Q: On whose behalf are you testifying?

A: My testimony is sponsored by Green Mountain Energy Company (GMEC), an Ohio competitive retail electric service (CRES) supplier, serving residential and small commercial customers in 113 communities through the Northeast Ohio Public Energy Council and AMP-O governmental aggregations in the service territories of Ohio Edison and Cleveland Electric Illuminating. I understand that GMEC is the largest CRES supplier in Ohio.

Q: What is the purpose of your direct testimony?

A: My testimony reviews the proposal of the FirstEnergy Ohio utilities (Ohio Edison, Cleveland Electric Illuminating, and Toledo Edison) to establish the regulations under which FirstEnergy would supply provider-of-last-resort (POLR) generation services to its customers. Among other things, I review FirstEnergy's proposals regarding (1) the prices of the POLR service it would charge customers, and (2) the portion of that price that consumers can avoid by taking service from competitive suppliers.

My testimony discusses aspects of FirstEnergy's proposed Option 2 "Rate Stabilization Plan" (RSP, or Plan). I do not discuss FirstEnergy's Option 1, competitive procurement of POLR, for two reasons. First, the Commission has requested a plan that would meet three specific criteria: rate certainty, financial stability for the electric distribution utilities, and the further development of competition (Entry in Case No. 03-1461-EL-UNC at 4–5 (September 23 2003)). The Commission appears to prefer that the utilities provide POLR service for a few more years and appears disinclined to transfer that responsibility to the competitive market. My testimony addresses why the RSP fails the Commission's criteria, and how it would need to be modified to be acceptable.

Second, FirstEnergy has structured its application to give the Commission a choice between accepting a particular RSP (as specified in Exhibit 2 to the Application) or launching a process to develop rules for competitive procurement (as sketched out in Exhibit 1 to the Application). FirstEnergy proposes specific egregious features of the RSP, which the Commission must address (by modifying, rejecting or accepting) in some detail in this proceeding. In contrast, FirstEnergy describes the competitive-procurement option in only general terms, leaving the details to negotiations and future proceedings (Application at 5).

Detailed discussion of the competitive procurement is neither timely nor necessary.

Q: What is the importance of the price that consumers can avoid by taking service from competitive suppliers?

A: That "price to beat," or "shopping credit," determines the feasibility of effective competition.

Q: Is price the only determinant of competition?

A: No. Competition also depends on the cost of power to suppliers (and hence to the market price of power in general); the costs of managing power supply, customer acquisition and retention, and billing; as well as such non-price barriers as excessive requirements for contract length, financial security and prior notification for switching. But competitive supply will not be available unless the shopping credit is large enough to cover the cost of power and the administrative costs of the non-price requirements.

Q: Please summarize your conclusions regarding FirstEnergy's proposal.

A: The proposal would allow FirstEnergy to charge considerably more for power-supply services than competitive suppliers could charge or than consumers would save on their FirstEnergy bill by switching to competitive suppliers. While FirstEnergy would charge the sum of tariffed Generation Rate *(g)* and the Rate Stabilization Charge (RSC) for power supply, customers would save only $g + 0.65 \times \text{RSC}$ or even just g by leaving FirstEnergy's power-supply service. FirstEnergy's proposal would allow FirstEnergy to recover large amounts of power-supply revenue from consumers even if FirstEnergy provided them with no power supply. FirstEnergy's proposed prices to beat are arbitrary and unrealistically low.

FirstEnergy has not justified its proposed pricing with any quantitative analysis.

FirstEnergy's Application and testimony misrepresent the power supply offered in FirstEnergy's Plan.

As FirstEnergy recognizes, the Commission has determined that to "best promote orderly and progressive market development in the post market development period" there must be a plan that will "balance three objectives: rate certainty, financial stability for the electric distribution utilities, and the further competitive-market development" (Entry in Case No. 03-1461-EL-UNC at 4–5 (September 23 2003)). Rather than balance the Commission's three objectives, as the Commission requested, FirstEnergy's RSP ignores two of the objectives and responds to the third with an unbalanced proposal, as follows:

- FirstEnergy's RSP would not provide rate certainty.
- While the proposal would be very good for FirstEnergy's financial welfare, its finances are stabilized only against downturns; there are many opportunities for upward instability in FirstEnergy returns, at the expense of consumers.
- The FirstEnergy RSP proposal would be antithetical to competition.

Q: Please summarize your recommendations.

A: I recommend that the Commission take the following steps:

- Set the 2005 shopping credits at the 2005 values in Supplemental Attachment 3 in the Case 99-1212 Supplemental Settlement Materials.
- Modify the RSP to meet all three of the Commission's objectives and provide a reasonable balance between them, as I discuss below, including the following provisions:

- Setting the shopping credit for 2006–2008 for each rate class at the sum of the *g* and RSC components of the rate schedule, so long as each customer class's shopping credits in 2006–2008 is at least equal to the shopping credits in effect in 2005.
- Adding any generation-related deferrals to the shopping credit, as FirstEnergy suggests in GMEC-9-5.[1]

III. Shopping Credits for 2005

Q: What is FirstEnergy's proposal for shopping credits in 2005?

A: If the RSP is approved, FirstEnergy proposes that the shopping credits for 2005 be frozen at the values in effect for 2004 (Plan §VIII.6), rather than rising to the values specified for 2005 in Attachment 3 of the Supplemental Materials in Case 99-1212 (attached as Attachment PLC-4). FirstEnergy has not proposed shopping-credit rates for 2005, if the RSP is not approved.

Q: How does FirstEnergy's proposal compare to the Commission's past practice?

A: The proposal would be a significant departure from past practice. The shopping credits for 2001 were set at the values specified for each class in Attachment PLC-4.[2] For 2002–2004, in Cases 01-2736, 02-2877, and 03-1461, the Commission applied the adder stipulated for 2001 to the market-support price stipulated

[1]I cite FirstEnergy's discovery responses as [requesting party]-[set number]-[request number], where the requesting party is a three- or four-letter abbreviation. The cited responses are attached in Attachment PLC-3.

[2]These are the product of one plus the multiplier at the bottom of Attachment PLC-4 times the market support price specified in Attachment 2 to the original settlement in Case 99-1212.

for the current year.[3] The 2004 credits (which FirstEnergy proposes for use in 2005), my understanding of the 2005 credits under the Commission's approach, and the 2005 credits specified in Case 99-1212 Supplemental Attachment 3, are summarized in the following table:

Shopping Credits for 2005
($/MWh)

	Company	FirstEnergy (continue 2004)	PUCO Method	Supp. Att 3
Residential	OE	51.71	54.65	54.65
	CEI	52.46	55.45	55.45
	TE	49.78	52.61	52.61
Commercial	All	45.47	48.35	55.79
Industrial	All	34.55	36.66	43.04

Q: Do you have any comments on the 2005 shopping credit?

A: Yes. In its September 23 2003 Entry on the 2004 shopping credits, the Commission rejected the Applicants' proposals to reduce shopping credits for 2004. Instead it ordered increases from 2003 to 2004, based on deficiencies in the competitive market and "the uncertainty a midcourse adjustment might have on market development at this time." The Commission explained as follows:

> Market development has not matured to the point of [justifying] deviation from the calculations in the Stipulation. There is the real possibility that the adjustment could cause certain customer classes to fall below 20 percent or that the market would not remain viable or attractive to suppliers. The FirstEnergy service territory still is not seeing the entry of new suppliers into the marketplace that would evidence a mature or robust competitive market. (Entry at 4)

As described in the testimony of Staff Witness Richard Cahaan (at 4–6), the factors listed by the Commission in September have not changed. Company Witness Anthony Alexander cites similar considerations at page 5 of his testi-

[3]The Commission deviated from that approach only once, for the industrial class in 2003.

mony. The Commission's reasoning for 2004 shopping credits applies equally to the 2005 shopping credits.

Thus, if the Commission is to be successful in moving competition forward, shopping credits for 2005 certainly should not be set below the values produced by the Commission's previous approach.

Q: Have conditions changed dramatically since the signing of the Supplemental Settlement Materials, in a manner that would argue for reducing shopping credits from the settlement levels?

A: No. While the markets have been in flux throughout the intervening period, forward prices for 2005 are as high now as the forecasts of market prices for 2005 were at the time the parties negotiated the May 2000 Supplemental Settlement Materials in Case 99-1212.

I have estimates of all-hours market prices for 2005 from three consultants in Case 99-1212. FirstEnergy witness Scott Jones projected a price of $28.75/MWh, FirstEnergy witness Judah Rose projected $31.50/MWh, and Ohio Consumers' Counsel's consultant, La Capra Associates, projected about $28/MWh. Excerpts from the exhibits of Messrs. Jones and Rose, and from La Capra's January 28 2000 presentation to the OCC, are attached as Attachment PLC-2.

Current forwards for 2005 are very similar to the range of expectations for 2005 market prices in 2000. *MegaWatt Daily* reported forwards for on-peak power of $38–$39/MWh delivered to Cinergy during the period of January 22–30 2004. On-peak prices for northern ECAR (which includes the FirstEnergy territory) have been running about 7% higher than Cinergy prices, which would suggest on-peak forwards for northern ECAR for 2005 of about $41/MWh. I have not seen any published off-peak forwards for any part of Ohio or ECAR

for 2005, but Northern ECAR off-peak prices have been running about $18–$26/MWh. Recognizing that the peak hours are about 45% of total hours, and off-peak about 55%, the all-hours average market price for 2005 would be roughly $29–$33/MWh. This range is slightly higher than the $28–$32/MWh range of projections at the time of the settlement.

Q: What are the implications of this stability in market prices for appropriate shopping credits in 2005?

A: The current expectations for market prices in 2005 are slightly higher than the projections the parties had available at the time they negotiated the shopping credits in the Supplemental Settlement. This relationship suggests that the 2005 shopping credits should be set at or above the levels specified in the Supplemental Settlement. As shown in the Supp. Att 3 column in the table at 8 above, these would be at least $43/MWh for industrial, $56/MWh for commercial, and $52.6 to $55.5/MWh for residential, depending on company.

Q: Do the factors underlying the Commission's decision in Case 03-1461-EL-UNC end with 2005?

A: No. In its Entry in Case 03-1461-EL-UNC (September 23 2003), the Commission expressed concerns about the fragility of competition in FirstEnergy's service territories. The Commission (at 4) recognized that "the FirstEnergy service territory still is not seeing the entry of new suppliers into the marketplace that would evidence a mature or robust competitive market." As long as this remains true, the Commission's reasoning in that Order continues to be applicable.

In addition, current forward prices for 2006 are a couple percentage points higher than current forward prices for 2005, and even higher above the

expectations at the time of the settlement. Any movement in shopping credits from 2005 to 2006 should be up, not down.

Thus, the class-specific shopping credits that the Commission sets to maintain competition in 2005 (which I suggest should be at the settlement level) should establish the minimum levels for shopping credits for the 2006–2008 period. This will serve the Commission's objective of developing competition, while providing rate certainty for customers.

Q: Your summary included a recommendation that shopping credits in the RSP should be set no lower than *g* + RSC for each rate schedule. Why is it appropriate to use the additional floor price of the 2005 shopping credits by class?

A: Some rate schedules have such low values of *g* and RSC that effective competition is extremely unlikely if shopping credits are set as low as *g* + RSC.

Cleveland Electric Rate Schedule	*g* + RSC
Residential Water And Space Heating	1.7 ¢/kWh
Street Lighting	1.0 ¢/kWh
Traffic Lighting	1.5 ¢/kWh

IV. Problems with the FirstEnergy Rate Stabilization Plan Proposal

Q: Please describe the aspects of FirstEnergy's proposal that are relevant to your testimony.

A: FirstEnergy's proposal has problems in at least three areas, as follows:

- The shopping credits are *much* lower than the generation prices that FirstEnergy would charge customers.
- The generation charges FirstEnergy proposes would not be guaranteed or fixed prices. In addition, unlike competitive suppliers under a fixed-term

contract, FirstEnergy would be free to terminate the Plan at the beginning of any year (Plan §VI).

- The competitive test that FirstEnergy proposes would not function effectively.

A. Generation Charges and Shopping Credits

Q: What generation charges does FirstEnergy propose for 2006–2008?

A: The FirstEnergy proposal would set the generation charge for each class at the sum of two charges: *g* and the non-bypassable RSC. The RSC would be equal to the Generation Transition Charge (GTC) that expires at the end of 2005 (Plan § II.2.a). The Generation Rate would be set at the *g* in effect on December 31 2005, but is subject to increase throughout the Plan period, starting on January 1 2006 (Plan § I.5, § II.1). The Plan would also give FirstEnergy the option of deferring some generation-cost increases for recovery in the non-bypassable Regulatory Transition Charge (RTC) (Plan § II.2.c).

Q: Would customers switching to competitive suppliers avoid paying First-Energy's proposed generation charges?

A: No. Customers who commit to a competitive supplier by the end of 2004 (a group I will call "early shoppers") would avoid *g* plus 65% of the RSC; those who switched after January 1, 2005 ("late shoppers") would avoid only *g* (Plan § II.2.b).[4]

[4]FirstEnergy is not even clear that all early shoppers would avoid the shopping credit of *g* + 65% of RSC. In §II.2(b) of the Plan, FirstEnergy limits eligibility to commercial and industrial customers and government aggregators. In GMEC-2-5, FirstEnergy states that "this point was clarified in the Technical Conference to include all aggregators, not just government aggregators." Then in deposition, Mr. Alexander retracted this concession, and asserts that only government aggregators would be eligible (Tr. 1/27/04 at 158–159).

Q: Has FirstEnergy provided a rationale for the specific generation charges it proposes?

A: No. The *g* rate was set in the settlements in Case 99-1212 to be a residual after all other cost components were subtracted from the overall rate. The RSC is simply the same number as the GTC. While FirstEnergy proposes to set the new RSC charge equal to the GTC, it insists that there is no real connection between the two charges: "the unbundled generation transition charge does not become the RSC; it is replaced by the RSC" (OCC-1-39). Whether a 2¢/kWh GTC *becomes* a 2¢/kWh RSC or *is replaced by* a 2¢/kWh RSC is merely a semantic distinction. For every rate schedule for each company, one item would disappear from the customer's bill and another item of identical magnitude would appear in its place.

Q: What is FirstEnergy's justification of the RSC rates?

A: FirstEnergy's rationale for the RSC prices is that those are the prices it wants to charge. In response to a request for the cost basis of the RSC charge, First-Energy explained:

> The Rate Stabilization Charge is a component of a market-based generation rate which, when combined with the generation charge as described in the Rate Stabilization Plan, as well as the rest of the provisions of the plan, is the market-based overall rate at which FirstEnergy Ohio operating companies are willing to provide stable long-term competitive pricing of energy services for customers over the 2006–2008 period, under the terms and conditions identified in the Rate Stabilization Plan. (NOAC-1-22)

Q: Has FirstEnergy demonstrated that the generation prices it has requested actually match market prices?

A: No. Indeed, FirstEnergy claims not to have any information about market prices to which its requested generation prices can be compared.

- FirstEnergy has no estimates of forward contract prices for delivery in 2006–2008 (GMEC-3-1). These would be the flat (e.g., 50-MWh-per-hour) contracts—generally for all on-peak hours (and sometimes for all hours, or off-peak hours) in a day, week, or month—traded in the wholesale market.
- It has not estimated the market cost of all-requirements power supply, if contracted today, for delivery to each customer class, for each year 2006–2008 (GMEC-3-3; OCC-1-1). These values would generally be higher than the flat, all-hours wholesale contract prices for the same years, since they would include (1) a larger percentage of energy in the on-peak hours; (2) more energy in the highest-load, highest-cost hours within any period; and (3) the risk of having to supply additional power in extreme weather conditions.
- FirstEnergy claims not to have determined historical prices for traded blocks or class loads (GMEC-5-1).

Q: Does FirstEnergy assert that the combined generation charges are market-based?

A: Yes. At pages 15–16 of his testimony, FirstEnergy witness Alexander claims that *g* + RSC is a market-based price. He supports this claim by asserting that "this generation price…averages approximately 4.6¢/kWh across all classes," and that the generation price "is consistent with market prices for similar service," of which he lists two: the final auction price of approximately 5.5¢/kWh for fixed price tranches, to serve residential and commercial loads in New Jersey from August 2003 through May 2006, and the Companies' 5.0–5.2¢/kWh shopping credits for residential customers in 2004.

Q: What seems to be the purpose of Mr. Alexander's generation-price comparisons?

A: First, Mr. Alexander seems to be suggesting that the comparison demonstrates that FirstEnergy's RSP would be a good deal for ratepayers, since Mr. Alexander asserts that FirstEnergy is proposing to provide generation services for less than the comparison generation prices he cites. Second, Mr. Alexander appears to be suggesting that proposed generation prices must be market-based, because the comparison prices are within ten or twenty percent of FirstEnergy's proposal.

Q: Do the comparisons demonstrate that the generation prices in the Plan are favorable to customers?

A: No. Mr. Alexander's comparisons understate the relative costs of the Plan to customers, in three ways. First, Mr. Alexander inappropriately compares (1) FirstEnergy's proposed generation-service prices for a system-wide average price to (2) FirstEnergy and New Jersey prices for service to residential and/or small-commercial customers. Second, under its proposal, FirstEnergy would be allowed to charge customers more than the average price Mr. Alexander claims, due to FirstEnergy's right to increase generation charges in the Plan.[5] Third, the FirstEnergy Plan has several features that impose additional costs and restrictions on customers, compared to the New Jersey POLR service.

[5]In addition, the prices are for different time periods and (in the case of the New Jersey auction results) different locations, so demonstrating that the FirstEnergy proposal is market-based would require market price data FirstEnergy has refused to provide and claims it has not collected (GMEC 3-1; 5-1). See also GMEC 8-27 and OMG-1-3, in which FirstEnergy claims that it monitored Cinergy forward energy prices over at least the past two years but "not in a systematic or formal basis."

Q: How is the comparison affected by Mr. Alexander's use of generation-service prices for different customer mixes?

A: The 4.6¢/kWh price is FirstEnergy's estimate of the average price across all classes.[6] The other prices he cites are for residential and/or small commercial loads, which generally have higher-cost load shapes (with a higher percentage of energy in on-peak periods, more kW of peak load per MWh of sales, and higher line losses) than large industrial loads. Ohio Edison proposes to charge residential customers at least 6.4¢/kWh for generation, which is substantially higher than the New Jersey auction results and the FirstEnergy 2004 residential shopping credits. FirstEnergy's proposed generation rates are roughly comparable to the comparison prices, not substantially lower.

Q: How has FirstEnergy designed its RSP so that it would charge more for POLR service than the price Mr. Alexander sponsors?

A: The 2004 shopping credit is fixed for each rate schedule for each FirstEnergy company, and the New Jersey supply cost is fixed for the contract period. In contrast, the prices that FirstEnergy is proposing to charge for power supply in 2006–2008 are not fixed, since FirstEnergy can increase *g* under a variety of circumstances, to reflect increases in fuel (and other fuel-related costs), environmental allowances, security, environmental costs, taxes, or regulatory requirements (Plan § I.5.d). Neither the 2004 shopping credits nor the New Jersey POLR service allow such adjustments for the generation costs of the suppliers.[7] I discuss this point further at page 29 below.

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[6]FirstEnergy's computation of the average generation price actually produces a value of 4.66¢/kWh (GMEC-6-4).

[7]The New Jersey POLR contracts allow for flow-through of increases and decreases in transmission rates, which would be the same for all suppliers, whether of POLR or of competitive services.

Q: What are the features of the FirstEnergy Plan that impose additional costs and restrictions on customers, compared to the New Jersey POLR service?

A: The New Jersey auction was for POLR power supply at a fixed price, for the customers who choose to stay on POLR or to return to that service. The competitive POLR suppliers in New Jersey receive no payment when customers choose other suppliers. In contrast, FirstEnergy's proposal would allow the Companies to take the following steps:

- increase prices for fuel (and other fuel-related costs), environmental allowances, security, environmental costs, taxes, or regulatory requirements;
- charge returning customers market prices, rather than the posted price, for the first six months after they return to POLR service (Application, Section II.2(b));
- charge 35% of RSC (which would be several dollars per MWh) to customers who go shopping more than a year before the rate period;
- charge 100% of RSC (about 2¢/kWh for residential and commercial customers (GMEC-10-1)) to customers who go shopping during the rate period, or less than one year before.

I describe these three latter features of the FirstEnergy proposal below at 18–28.

Q: Would the competitive risks that FirstEnergy would bear under the RSP be comparable to the risks that the New Jersey POLR suppliers face?

A: No. The price that Mr. Alexander cites for the New Jersey POLR is both the price that the suppliers are paid and the shopping credit, the price against which competitors must compete. Under the FirstEnergy Plan, the shopping credit for each rate schedule would be lower than the generation price FirstEnergy would charge. This difference is very important, since it means that competition would

be severely restricted under the FirstEnergy proposal and that FirstEnergy would face little risk of migration from its service to competitors if market prices fall.

In contrast, the New Jersey power suppliers who agreed to provide POLR service at 5.5¢/kWh knew that the retail customers could choose an alternative supplier and avoid the entire POLR charge, creating the risk that the POLR load would fall (requiring the suppliers to sell resources into the market, perhaps at a time of low prices) and the risk that customers with favorable load shapes would leave (increasing the average cost of service).

Q: Could these features of the FirstEnergy Plan increase the cost to customers, increase revenues to FirstEnergy, and reduce FirstEnergy's risk, compared to the rules that apply to the New Jersey POLR service?

A: Yes. FirstEnergy's proposed generation charges would give it g + RSC for non-shoppers, 35% × RSC for early shoppers, and RSC for late shoppers. If 30% of load shops early and 5% shops late (although late shopping would be unlikely, given the low shopping credit), then for every kWh of non-shopping generation load served, FirstEnergy would receive g plus 1.24 times the RSC for each kWh it actually delivers. The New Jersey POLR suppliers would receive the contract rate for each kWh provided, regardless of the fraction of load that switches to other suppliers.

In addition, FirstEnergy would receive the market (or potentially above-market) prices charged to returning customers (Plan § II.2.b), which may be substantially higher than the posted generation rates.

Q: Has FirstEnergy provided a rationale for charging g + RSC for generation service, while charging 35% of the RSC for early shoppers and limiting the shopping credits to g + 65% × RSC?

A: Yes. Mr. Alexander (at 12) describes the 65% of the RSC included in the shopping credit as "a reasonable estimate of the reduction in risk to the Companies for their commitments due to customers contracting elsewhere for long-term generation supply." However, FirstEnergy admits that it has no support for that statement (GMEC-9-28). Mr. Alexander suggests that FirstEnergy is justified in retaining 35% of the RSC for shopping customers due to "the risk of supplying returning customers at the fixed prices offered." He describes 35% of the RSC as "a charge to reserve capacity or to otherwise bear the cost of higher market prices for the entire period in which the customer might return to the Companies for generation service."

Elsewhere, FirstEnergy suggests that part of the RSC is compensation for discounts in other rates (GMEC-1-46), but while FirstEnergy projects the total value of the discounts (OCC-1-25(a)); GMEC-5-3), it has no estimate of RSC revenues for 2006–2008 (GMEC-1-34; NOAC-1-21).

Q: Has FirstEnergy justified the specific risk adder of 35% of the RSC for early shopping customers?

A: No.

Q: What does the 35% of RSC amount to in cents per kWh?

A: The RSC, and hence the risk adder, varies by rate class. Examples of this alleged risk adder are shown below for some of the major residential classes (OCC-1-17 Supp.):

	RSC (¢/kWh)	.35 RSC (¢/kWh)
Ohio Edison Rate 10	2.2	0.77
Cleveland Electric Std Res Rate	1.8	0.63
Toledo Edison R-01	2.3	0.81

Q: Does FirstEnergy bear a large risk related to returning customers?

A: No. While FirstEnergy's proposed POLR service certainly has some risk, the Plan would mitigate FirstEnergy's risk and reduce its costs in at least five ways, as follows:

First, FirstEnergy can sell the power in the market it has on "reserve" when it is not being used to "supply returning shoppers." Hence, FirstEnergy would receive market revenues for the current energy production from its generation resources, even while keeping them available to serve returning load in the future. FirstEnergy seems to suggest that it must be compensated for the cost of those plants entirely through the RSC charges to shopping customers. Indeed, since FirstEnergy would serve customers at market rates for six months after they return to POLR service, FirstEnergy could commit unused generation to serve other customers six months in advance.

Second, FirstEnergy would not guarantee fixed prices. FirstEnergy would be able to increase the generation price for post-2002 increases in fuel cost, so if fuel prices drive up market prices, the generation prices would tend to rise in step. FirstEnergy could also increase the generation price to reflect a variety of taxes and environmental and regulatory requirements.

Third, if the returning customers were a burden, FirstEnergy could opt out of the Plan, by shutting down 250 MW of its oldest plants (Application, Exhibit 2, Section VI, at 11–12). As I discuss below, FirstEnergy may be able to invoke this provision by shutting down units that actually provided less than 250 MW.

Fourth, FirstEnergy is not offering to take customers back immediately onto the generation price, even with all the potential upward adjustments. For the first six months after the customer returns to the utility's generation service, FirstEnergy would charge "the then-current market price for electricity, based upon the average of the highest purchased power costs incurred by any affiliate of FirstEnergy to serve any of its customers during the applicable month"

(Application, Section II.2(b)). FirstEnergy would bear no market risk in this period.

Fifth, FirstEnergy is planning, if the RSP is approved, to require some unspecified higher guarantee of creditworthiness, which would greatly decrease FirstEnergy's already low exposure to supplier default, or simply force suppliers out of business prior to the start of the Plan.

Q: Would FirstEnergy's formula of "the highest purchased power costs incurred by any affiliate of FirstEnergy to serve any of its customers during the applicable month" reasonably approximate "the then-current market price for electricity?"

A: No. The highest price paid for energy delivered the current month may be a price for power contracted months earlier, at the beginning of the month, the day before delivery, or minutes before delivery. The highest price might be for a small amount of energy purchased for just a few hours, or it might be the price for block of power purchased for delivery over several months. In most months, the highest purchased-power costs will be considerably greater than the market price for serving customer load over the month.

Even though FirstEnergy proposes to use this unusual and volatile method for determining generation prices for returning customers, it has refused to provide historical information that would indicate by how much prices from its formula would exceed market prices (NOAC-2-16).

In addition, the phrase "any affiliate of FirstEnergy to serve any of its customers" could include the operations of FirstEnergy Solutions in any part of Ohio, as well as Michigan, New Jersey, Pennsylvania, Maryland, Delaware, Illinois, or New York, all of which FirstEnergy Solutions serves currently.

In his deposition, Mr. Alexander indicates that the computation would be limited to the highest cost of purchases for "operating companies of First-Energy," and then lists just FirstEnergy's Ohio and Pennsylvania utilities (Tr. 1/28/04 at 250–251). Hence, FirstEnergy may mean purchases by any affiliate (as the Plan specifies), only the Ohio and Pennsylvania utilities (from Mr. Alexander's list), or all FirstEnergy-affiliated utilities, including Jersey Central Power & Light and future acquisitions or acquirers (from Mr. Alexander's term "operating companies").

Q: Please summarize the compensation that FirstEnergy requests for accepting the POLR obligation to serve returning customers.

A: The amount of compensation that FirstEnergy would receive under the Plan for each kWh of energy actually provided would depend on whether any supplier ever defaulted, and if so, when the default occurred and when the supplier's customers returned to POLR service. For an early-shopping customer who returned to FirstEnergy POLR service in the middle of the three-year Plan period, FirstEnergy would only provide power at the g + RSC rate for one year, following 18 months of charging 35% of RSC for no service and six months of charging market rates or higher *plus* the RSC. The resulting generation charge per kWh provided at the Plan rates for the average residential customer returning in the middle of the Plan period would range from 6.2¢/kWh for Cleveland Illuminating to 7.9¢/kWh for Ohio Edison.[8] These prices are 83% and 74%, respectively, more than the shopping credit against which FirstEnergy would have marketers compete.

[8]This computation does not include the market or above-market rates FirstEnergy would charge the customer for the first six months after the customer's return.

			Revenues at 1,000 kWh/month					
	RSC[a]	***g*[a]**	35% of RSC for 18 months before return	RSC during 6 months at market[b]	RSC + *g* for 12 months after return	Total	**kWh at Plan price**	**Average Price** (¢/kWh)
Ohio Edison	2.1	3.6	$132	$126	$684	$942	12,000	7.9
Cleveland Electric	1.8	2.6	$113	$108	$528	$749	12,000	6.2
Toledo Edison	2.3	2.1	$145	$138	$528	$811	12,000	6.8

[a]Cents per kWh, from OCC-1-16, OCC-1-17 Supp.

[b]Were FirstEnergy to charge prices above market costs, as allowed by the RSP, the costs in this column would be much greater.

Suppliers are least likely to default at the beginning of the Plan period. For a customer that returned at the beginning of 2008, the price per kWh delivered under POLR would be 8.7¢–10.7¢/kWh, or 2–3 times the shopping credit.

			Revenues at 1,000 kWh/month					
	RSC[a]	***g*[a]**	35% of RSC for 18 months before return	RSC during 6 months at market[b]	RSC + *g* for 12 months after return	Total	**kWh at Plan price**	**Average Price** (¢/kWh)
Ohio Edison	2.1	3.6	$176	$126	$342	$644	6,000	10.7
Cleveland Electric	1.8	2.6	$151	$108	$264	$523	6,000	8.7
Toledo Edison	2.3	2.1	$193	$138	$264	$595	6,000	9.9

[a]Cents per kWh

[b]Were FirstEnergy to charge prices above market costs, as allowed by the RSP, the costs in this column would be much greater.

Q: Has FirstEnergy justified its proposal to reduce the shopping credit for late shoppers to just *g* and to charge those customers 100% of RSC, even though they would receive no generation service from FirstEnergy?

A: No. Neither the Application nor the testimony makes any qualitative effort to justify further reducing the shopping credit for customers that have not entered

into full-service contracts for 2006–2008 by December 31 2004. Mr. Alexander asserts (at 18) that

> the RSC essentially compensates the Companies for, among other things, the cost of reserving affiliate generation to "backstop" Ohio POLR service. The price…compensates FirstEnergy for maintaining the ability to provide generation to all its shopping and non-shopping customers.

and (at 19) that

> The RSC is in place to compensate the Companies for the cost of reserving and supplying generation to cover all potential POLR load in Ohio.

FirstEnergy has not gone beyond the assertion that it would bear some risk or cost, to justify the specific value of the penalty applied to either early or late shoppers to compensate FirstEnergy.

Indeed, when asked on discovery to provide evidence that the RSC would be reasonable compensation to the Applicants for "the cost of reserving and supplying generation to cover all potential POLR load in Ohio" (Mr. Alexander's own words), FirstEnergy refused to respond and objected that "margins to the Companies…are irrelevant" (GMEC-8-53). The question does not mention "margins" at all; it simply requests the basis for a critical assertion in its testimony regarding the reasonableness of its proposed prices. Rather than support its testimony, FirstEnergy asserts that RSP prices are irrelevant to this proceeding.

Reducing the shopping credit to *g* harms both consumers and competitive suppliers by effectively precluding competition. FirstEnergy has not justified this proposal, which the Commission should reject.

Q: Does the relationship of the RSP generation prices to market prices have any special significance in this proceeding?

A: Yes. Sec. 4928.14(A) of the Ohio Revised Code requires that:

> After its market development period, an electric distribution utility in this state shall provide consumers, on a comparable and nondiscriminatory basis within its certified territory, a market-based standard service offer of all competitive retail electric services necessary to maintain essential electric service to consumers, including a firm supply of electric generation service.

As I read this language, the Commission must find that the price of the standard service offer, or POLR service, in the RSP is "market-based."[9] Other than Mr. Alexander's sweeping assertions and inappropriate comparisons, First-Energy has failed to demonstrate that the RSP prices (including the charges for customers who are not taking supply services from FirstEnergy) are market-based.

Q: Does FirstEnergy offer any rationale for radically reducing shopping credits for customers without contracts for 2006–2008 by the end of 2004?

A: Only indirectly. Mr. Alexander's testimony at 25–26 argues that FirstEnergy needs an early resolution of this proceeding, in order to determine how much capacity will be committed to serving Ohio POLR load for 2006–2008. First-Energy may believe that the December 2004 cut-off date for the higher (but still low) shopping credits would be beneficial to FirstEnergy's planning.

In deposition, Mr. Alexander expanded on this point:

> It might take a couple years to be able to lock [power supply commitments for the RSP period] all down and fully hedge your risk both on-peak and off-peak in that marketplace.... (Tr. 1/27/04 at 143, lines 11–14)

> ...[Building a portfolio of power supply contracts] could take [a couple years] to put it all together. (Tr. 1/27/04 at 144, lines 22–24)

Mr. Alexander suggests that it would be even more difficult for another supplier to assemble its portfolio:

[9]My understanding of this passage was confirmed with counsel.

> you have to build a portfolio of supply against that obligation and it's much more complex without the FirstEnergy Solutions generation as its base. (Tr. 1/27/04 at 143, lines 11–14)

Thus, FirstEnergy wants to have it both ways: years of lead time for FirstEnergy to prepare its POLR portfolio, but months or weeks for potential competitors to prepare their portfolios. If FirstEnergy is telling the truth about its lead-time requirements, it is designing all the alternatives in the Plan to fail, forcing the PUCO to continue the FirstEnergy's role as POLR supplier, no matter what. If FirstEnergy is exaggerating its lead-time requirements, it is proposing to unnecessarily limit shopping with arbitrary deadlines and penalties. In either case, the effect would be to stifle competition; the Commission should reject FirstEnergy's proposals.

Q: Is FirstEnergy's proposal to impose generation charges on shopping customers common in restructured markets?

A: No. In the states with which I am familiar (e.g., New Jersey, New York, Maryland, Massachusetts, Connecticut, Maine, Rhode Island), POLR suppliers are paid the POLR price for the load that does not go shopping, and receive no extra payments from customers who select alternative suppliers. Some states allow utilities to impose constraints or surcharges on customers returning to POLR (comparable to FirstEnergy's proposal to charge returning customers market rates for the first six months), to minimize frivolous or opportunistic shifting.

Q: Do the other states with restructured markets require customers to secure competitive supply years in advance, or face higher charges, as FirstEnergy would?

A: No. FirstEnergy has demanded that the Commission determine whether First-Energy will be supplying POLR by the beginning of this year, two years before

deliveries start and five years before the end of the POLR period.[10] FirstEnergy would also increase charges (to punitive levels) to customers who dare to go shopping without having secured firm contracts with a supplier one year prior to the beginning of delivery and four years before the end of the period.

Most POLR suppliers are not even *selected* one year prior to the start of delivery, and have no right to impose a surcharge on customers based on when they choose to go shopping. For example, New Jersey has been conducting auctions in February for power supply to start in August; New Jersey customers can go shopping at any time without paying a surcharge.

Furthermore, even FirstEnergy does not believe that other POLR suppliers would require two-year notice from the Commission, or one-year notice from customers. FirstEnergy has opined that, if the Commission selects its Option 1 (competitive acquisition), the bid process for POLR service would need to start by "the first week of July 2005," which would leave suppliers with perhaps five months to make supply arrangements for January 1 2006 (OCC-3-72). First-Energy has also suggested that the bidders in the competitive test it proposes within the RSP (§IV.1 of the Plan) should bid to supply power for a single year, so they would never have two years' advance notice, let alone the four years FirstEnergy demands to provide POLR in 2008.

Q: Can you quantify the magnitude of the RSC charge for late shoppers?

A: The RSC charge varies by rate schedule and company. For the principal residential rates, the RSC is more than half the value of *g,* which would be the shopping credit for these customers:

[10]FirstEnergy did not receive the Commission's decision in this proceeding by December 31 2003, as it requested in its Application (at 12). It continues to press for a decision early this year.

	RSC (¢/kWh)	*g* (¢/kWh)	Ratio of RSC to *g*
Ohio Edison Rate 10	2.2	4.2	52%
Cleveland Electric Std Res Rate	1.8	3	60%
Toledo Edison R-10	2.3	2.6	88%

RSC and g *are from FirstEnergy's reported values for the year ended March 30 2003 in OCC-1-16 and OCC-1-17 Supp.*

Under FirstEnergy's proposal, late-shopping residential customers would pay FirstEnergy at least 52–88¢ *not* to provide them generation services for every dollar they paid a competitive supplier to actually provide those services. The situation would be even more ridiculous for the rate schedules with negative *g,* such as CEI's Residential Water and Space Heat class, which has *g* charges as low as ⁻1.82¢/kWh in summer and ⁻1.26¢/kWh in winter (CEI Tariff Sheet No. 14 at 3rd revised 2 of 5), or the CEI's commercial Electric Space Conditioning Schedule, which has a *g* of ⁻2.28¢/kWh in the summer (Ibid. Sheet No. 31 at 1 of 3). FirstEnergy would charge those customers more if they (miraculously) found an alternative supplier than if they took power from FirstEnergy.

It is difficult to see how these arbitrary and widely variable *g* rates could be considered to represent "nondiscriminatory" provision of POLR service as required by O.R.C. Sec. 4928.14(A).[11]

B. FirstEnergy Would Not Assure Customers of Fixed Generation Prices

Q: Under the Plan, would FirstEnergy be committing to price or supply certainty?

A: No. Mr. Alexander asserts (at 11) that "the Companies will commit to price and supply certainty for generation service for the duration of the Plan." He further claims (at 23–24) that the Plan gives customers "the best of both worlds,"

[11]Counsel confirms my understanding that the statute prohibits discrimination.

namely protection against high market prices and an early termination option that would allow customers to take advantage of low market prices:

> If the Plan is adopted, FirstEnergy's generating affiliate will dedicate a significant portion of its generating assets to the Companies customers. As such, FirstEnergy forgoes the potential benefits of a high-priced market during the Plan period while still assuming the risk of a low-cost market. (Alexander at 22)

In fact, the Plan would provide neither price certainty nor supply certainty. The Plan would allow FirstEnergy to substantially increase generation prices, and, if market prices were high, would allow FirstEnergy to terminate the Plan, leaving customers high and dry in a tight market.

Q: What price adjustments would be permitted under FirstEnergy's Plan?

A: The Plan (at 10–11) would permit FirstEnergy to raise *g* for cost increases above some baseline level for a wide range of costs, including fuel, fuel disposal, nuclear security and environmental costs, regulatory costs and taxes. The Plan does not specify what cost items would be included in these broad categories nor how the adjustments would be calculated.

For example, the Application does not

- provide baseline costs for nuclear security, environmental costs, regulatory costs and taxes. (OCC-1-5 indicates that FirstEnergy does not intend to propose baselines and a method for calculating cost increases until it requests a cost adjustment.)
- provide a list of taxes to which the increase for taxes would apply, or a formula for computing that increase. (In GMEC-9-16, FirstEnergy admits that it does not know what taxes might be covered, and cannot provide a formula or even the concepts and procedures from which that formula would be developed.)

- indicate whether a change in allocation of resources between the First-Energy operating companies and its other wholesale sales could affect the calculation of the fuel cost increase.

Q: Would these adjustments to *g* be limited, as FirstEnergy suggests?

A: No. Under the Plan, there would be no cap on the level of adjustments permitted. The relevant provisions are as follows:

- The Plan would permit an annual 15% increase in *g* for fuel, nuclear-security and environmental cost increases, and a total increase over the three years 2006 to 2008 of more than 50%. If the increase is less than 15% in one year, FirstEnergy is permitted a catch-up increase in the next year (Plan §I.5.(c)). So if the 2006 increase is 5%, the 2007 increase could be 15% plus the unused 10% from 2006, or a total of at least 25%.[12]
- Any increase in fuel, nuclear safety and environmental costs that exceeded the limit of 15% per year could be deferred for recovery in the RTC, a non-bypassable charge. (Application, I.5.(c)).[13]
- FirstEnergy intends to flow through the fuel provision some increases in purchased-power costs that "can be clearly attributed to an increase in fuel costs" (GMEC-9-11).
- In the event that FirstEnergy power plants were out of operation, First-Energy could request recovery of replacement purchased-power costs

[12]It is not clear whether FirstEnergy intends that the catch-up increase would be limited to the arithmetic difference between the first year's increase and 15%, or whether it could bring the compound increase for the two years to $1.15^2 = 1.3225$. In the example above, the latter interpretation would allow the increase in 2007 to be 26%.

[13]FirstEnergy could also decide to defer costs under the 15% limit, at its sole discretion (OCC-1-35; Wagner at 4).

(OCC-1-31). Again, FirstEnergy does not specify when those costs would be recoverable, and when they would not.

- The Plan would permit additional increases in *g* for increases in regulatory costs and taxes. Increases in these two categories would not be limited by the 15% cap, or by any cap (Plan, §I.5.(d)).
- Rate increases for tax changes could be based on any combination of local, state, or Federal taxes, and could reflect changes in assessments, tax rates, and increased investment, as well as changes in laws or rules (GMEC-9-15).
- FirstEnergy would be allowed to increase rates by more than the total increase in costs. Reductions in one or more of the components cannot be used to offset an increase in the other components (OCC-1-36). Were fuel costs to grow $50 million, while regulatory costs decline $10 million, and taxes decline $40 million, FirstEnergy could still claim a $50-million increase in *g,* even though its eligible costs had not increased at all.
- The Plan seems to imply that fuel, nuclear-security, and environmental costs would be treated as a single category, allowing offsets among those sub-categories. However, GMEC-9-35 states clearly FirstEnergy's intention to the contrary: when asked whether an increase in nuclear security costs would be offset by a decrease in fuel costs, FirstEnergy answers "No."
- FirstEnergy does not accept the burden of proof to demonstrate that it has provided adequate documentation for the Commission to quantify all off-setting cost decreases, even under its own rules (GMEC-9-35). FirstEnergy has not explained how other parties would develop the data necessary to quantify offsets, especially since FirstEnergy has not proposed baselines for most cost items.

Q: What rationale does FirstEnergy offer for proposing rate increases that more than compensate for cost increases?

A: FirstEnergy believes that the adjustments should not be limited to the actual cost increases, because

> The tariffed generation charges…anticipated to be in effect at December 31, 2005 are well below costs for providing generation services. There is no reason to agree to drive recovery lower by allowing the described offsets across categories. (OCC-1-36(b))

This response is peculiar in two respects. First, allowing offsets between cost categories could not "drive recovery lower" than the "charges in effect at December 31, 2005." The issue here is whether FirstEnergy should be allowed to increase rates by more than its increase in costs, by ignoring offsetting cost reductions. Reflecting offsets might reduce the *increases* in generation charges from 2005 through 2008.

Second, since Mr. Alexander asserts that the generation prices FirstEnergy has proposed (g + RSC) are market-based, it would be very surprising if FirstEnergy were arguing that the proposed generation prices are "well below costs." FirstEnergy appears here to be comparing the g rates (which it often calls "tariffed generation charges") to the "costs for providing generation services." That is an irrelevant comparison, since FirstEnergy has proposed to charge much more than g for generation services.

In short, FirstEnergy appears to be anticipating that generation rates under its Plan would exceed g + RSC, by an amount now known only to FirstEnergy. Further, FirstEnergy proposes that it should receive those higher rates, even if net costs do not increase.

Q: Does the Plan constrain deferral of allowed increases through the RTC?

A: No. Under the Plan, FirstEnergy could choose to defer any portion of the increase in the fuel, nuclear-security, and environmental costs, not just the excess over 15% (Plan §I.5(c); GMEC-9-30; Testimony of Company Witness Harvey Wagner at 3–4).

The Commission would not have approval authority over the deferral of these increases. It would only approve or disapprove the requested increase; once approved, the portion of the increase to be deferred would be at First-Energy's discretion (OCC-1-35).

This ability to defer cost increases would allow FirstEnergy additional options for manipulating shopping credits. Not only could it time its requests for generation charge increases but it could also hide a portion of those increases in the non-bypassable RTC charge, increasing FirstEnergy's recovery of generation costs without increasing *g*.

The Commission should not allow deferral of POLR costs. POLR service is an alternative to competitive power supply; any POLR costs the Commission approves should be collected through current charges and included in the shopping credit that is avoided by customers who select a competitive supplier.

Q: Please explain the provision under which FirstEnergy can terminate the Plan.

A: The Plan (at §VI.1) includes an open-ended escape clause for FirstEnergy if it is willing to shut down a 250-MW unit:

> The Companies may terminate the Plan, effective as of any January 1, at any time during the term hereof by providing written notice to the Commission, if any generating units currently owned by any of the Companies, and which in the aggregate exceed 250 MWs, are permanently shut down, retired or abandoned as a result of environmental requirements, including a decision by the Companies not to install or make environmental additions or changes at any such facility.

Q: In what ways is this termination provision open-ended?

A: In the following ways:

- Virtually any shutdown can be described as environmental.
- FirstEnergy would measure the capacity loss based on a generating plant's nameplate capacity (OCC-1-49). If the shutdown unit had previously been derated, the nameplate capacity could be overstating the actual capacity lost. Hence, FirstEnergy might be giving up little actual generation value in retiring capacity rated at 250 MW.[14]
- FirstEnergy is not precluded from re-starting shut-down units.[15]
- The Companies' termination of the Plan under this provision does not require Commission approval.
- FirstEnergy's termination of the Plan under this provision does not require advance notice (GMEC-3-5), leaving the Commission to scramble for alternative supply with little or no notice.
- In case 99-1212, FirstEnergy witness Scott Jones projected retirement of Ashtabula 6, 8, and 9; Avon Lake 6 and 7; Burger 3–5; Eastlake 1–3; and Niles 1–2 at the end of 2005, and Eastlake 4 at the end of 2006 (Attachment STJ-13). These units total nearly 1,500 MW, six times the retirements necessary to trigger termination.
- A Federal judge found that FirstEnergy violated the Clean Air Act by failing to comply with New-Source Review for the Sammis plant.[16] Space is

[14]In his deposition, Mr. Alexander indicated that the "net demonstrated capacity" of plants would be used in determining whether the 250 MW threshold had been exceeded (Tr. 1/27/04 at 41). His testimony appears to contradict FirstEnergy's discovery response.

[15]FirstEnergy asserts that it could not could shut down a unit, terminate the Plan, and then restart the unit at a later date, but could not explain how the Commission could prevent such a course of action (GMEC 3-6(a)).

highly constrained at the Sammis site, so much so that the owners built a deck over the adjacent highway to hold electrostatic precipitators. If Sammis is required to install scrubbers to control SO_2, FirstEnergy may have little choice but to demolish one or two of the four oldest units (built 1959–62) to make room for the equipment. Each of the four oldest units has a nameplate rating of 185 MW. Retiring one of these units would bring FirstEnergy close to the 250-MW threshold; retiring two would put it over the threshold. FirstEnergy could then terminate the Plan at its option.

As long as FirstEnergy has this open-ended right to terminate the Plan, there is no real price stability. If market prices rose, FirstEnergy would have the incentive and ability to back out of the agreement, leaving customers vulnerable to the higher market prices. Rather than simply walking away from POLR service, FirstEnergy could use the early-termination provision to pressure the Commission and the parties to renegotiate the Plan. Especially since FirstEnergy would not be required to give the Commission enough notice to conduct an effective competitive procurement, FirstEnergy could place the Commission in the situation of choosing between authorizing a richer deal for FirstEnergy or relying on emergency purchases from the market.[17]

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[16]United States of America, et al., v Ohio Edison Company, et al.; United States District Court for the Southern District of Ohio. Eastern Division, Case No. 2:99-CV-1181.

[17]In this proceeding, FirstEnergy has threatened to withdraw the RSP if its objectives regarding the timing and language of the approval were not met. See 12/3/03 Transcript at 73–74, where FirstEnergy's counsel threatened that the Applicants could consider "whether we simply withdraw the action or not." See also Mr. Alexander's testimony (at 24) that "If, however, the Commission… makes any modifications to the Plan that are not accepted by the Companies in writing by that date, the Companies' Plan will be deemed to be withdrawn."

In principle, if market prices fell, the Commission could trigger a competitive bidding process and if it accepted the bid results, terminate the Plan. In reality, as I describe below in §IV.D, the flaws in the Plan's competitive bidding process would make that process slow and probably ineffective. Thus, upward increases due to FirstEnergy's very effective right to withdraw (or to use the threat of withdrawal to raise prices) would be more likely than decreases due to the Commission's more constrained withdrawal rights.[18]

Q: Has FirstEnergy provided any information regarding the probability that it would retire 250 MW of generation?

A: No. FirstEnergy objected to providing relevant data on life expectancy, availability and output; on pending environmental requirements, improvements, or unresolved environmental issues; and on the expected or potential costs of compliance (OCC-2-62; GMEC-3-4). It claims in GMEC-2-18 that no studies of the potential shutdown are even planned. FirstEnergy goes so far as to claim that listing FirstEnergy generating units "required to begin the installation of or make environmental additions or changes" would be "irrelevant," even though the number of such units would affect the probability that FirstEnergy would invoke its termination rights (NOAC-2-24).

[18]Section V.2 of the Plan would give the Commission a broader right to terminate the Plan, although it would still have to give FirstEnergy a year's notice, while FirstEnergy could terminate without notice. In any case, The Commission would not likely terminate until it could secure an alternative power supply. Were that alternative limited, power procured through the competitive test described in §IV, the Commission's actions will be tightly constrained. If §IV does not prevent the Commission from undertaking other power-supply activities on behalf of consumers, it is not clear what §IV accomplishes.

C. Effect of the Plan on Retail Competition

Q: Does FirstEnergy demonstrate that the Plan would adequately balance the Commission's criterion of "further development of competition" or "orderly and progressive market development?"

A: No. Mr. Alexander addresses the benefits of the Plan to FirstEnergy (at 20–21) and exaggerates the extent of the rate certainty the Plan would afford customers (at 20), but does not attempt to show that the Plan would do anything to further the orderly and progressive development of competition. The best he can do (at 20) is to characterize charging a limited group of shopping customers 35% of RSC as "provisions to support shopping," presumably because FirstEnergy would be charging less than 100% of RSC.

Q: How would the Plan affect retail competition?

A: Competitive aggregators and suppliers would compete against shopping credits that are much lower than the generation prices FirstEnergy would charge. For early shoppers, competitors would need to charge less than FirstEnergy by at least 35% of RSC; while for late shoppers, competitors would need to charge less by the entire value of RSC. If g + RSC represents the market price of power, as Mr. Alexander claims, competitors would need to charge substantially less than market price.

Q: Would non-price provisions of the Plan also be anti-competitive?

A: Yes. The reduction of the shopping credit from g + RSC to just g for customers who do not have contracts in place for 2006–2008 by December 31 2004 has three important effects.

First, suppliers who have already contracted to serve customers beyond December 31 2005 at prices tied to the shopping credit could be financially devastated by the dramatic reduction in shopping credits at that date.

Second, competition will become essentially impossible after December 31 2004, leaving marketers unable to recruit new customers until 2009 (if any marketers could still be operating in Northern Ohio, under the conditions imposed by the Plan). Not only would the marketers not be able to grow their businesses, they would not be able to replace load lost for any reason.

Third, while FirstEnergy has claimed in discovery (GMEC-8-1) that the requirement in §II.2(b) of the Plan that customers have a contract with a "creditworthy" supplier that is "acceptable to the Companies" would be similar to existing security requirements, Mr. Alexander states that FirstEnergy intends to impose unspecified but more-stringent standards (Tr. 1/27/04 at 151–159). Mr. Alexander anticipates that, whenever FirstEnergy decides what its standards will be for allowing its competitors to function, the competitors would have to initiate a complaint with the Commission to amend those requirements; First-Energy would not file the standards for prior Commission approval (Tr. 1/27/04 at 163). Those higher standards, the uncertainty about the level of the standards, and the delay required by the process of a complaint could force many suppliers out of FirstEnergy's service territory.

Q: Are there similar barriers to competition in other restructured markets?

A: Not that I am aware of. The dramatic reduction of the shopping credit (but not of the generation price) so long in advance—a year before the beginning of a rate period and four years before the end of the period—appears to be unprecedented. In other states with active competition—New York, New Jersey, Pennsylvania, Massachusetts, Rhode Island, Connecticut, Maine—customers receive the same shopping credit for a given year, regardless of when they switched suppliers.

Q: Does FirstEnergy argue that the *g* rate alone should be sufficient to allow for competition?

A: No. FirstEnergy clearly agrees the "tariffed generation charges *[g]*…are well below costs for providing generation services (OCC-1-36(b); 1-46).

Not only would the generation rates not be fixed, but the increases in those rates would not be predictable, or tied to any external cost index. The costs collected through *g* would be determined by FirstEnergy's decisions regarding cost deferrals, regulatory compliance strategies, and (depending on what FirstEnergy's vague proposal means) possibly other FirstEnergy decisions regarding tax management and accounting.[19] The allocation of the costs among companies and rate classes would be unpredictable and at the whim of First-Energy (OCC-1-10).

Q: How does the role of FirstEnergy Solutions affect the competitive issues in this proceeding?

A: In addition to being the supplier of POLR under the Plan, FirstEnergy Solutions is also a major competitive marketer, the second-largest supplier to Ohio customers who are served competitively through governmental aggregation. Since any losses to FirstEnergy Solutions as a marketer under the Plan would be offset by gains for FirstEnergy as a POLR supplier, FirstEnergy Solutions would be injured much less than other marketers by the inequities in the Plan. The operation of the Plan could thus leave FirstEnergy Solutions in a much-

[19]While FirstEnergy claims that all of these cost categories are "generally beyond the Companies' ability to control" (Application, Section C, at 8), FirstEnergy would have considerable control over the timing of many costs, the form of compliance with many directives, and the amount of cost deferred.

improved competitive position after the Plan period, while crippling its competitors.

Considering these conflicts of interest, the Commission should be very reluctant to allow FirstEnergy to set shopping credits below the rates it charges for generation. FirstEnergy cannot be assumed to be a neutral administrator of the competitive market, furthering the best interests of the customers and marketers. Instead, the Commission should treat with suspicion all interactions between FirstEnergy Solutions and the distribution utilities, and periodically audit FirstEnergy Solutions to ensure that losses by the wholesale supply operation are not being covered by the regulated utilities.

Q: What would happen to customers and their suppliers who already have contracts in place extending into the 2006–2008 period?

A: If the contract were not extended through December 31, 2008, the Plan would give those customers a shopping credit of only *g,* generally well below their current shopping credits. If the existing contract sets the competitive generation price at a discount off the shopping credit, the generation price would generally fall below market cost; a supplier with a large fraction of load under such contracts could be in serious financial difficulty. If the existing contract sets a fixed competitive generation price through the term of the contract, the customer will save only *g* on its FirstEnergy bill, while paying much more to the supplier, and will be harmed significantly. Either way, the Plan would likely trigger a storm of litigation.

Q: For those customers currently under contract through 2006 or 2007, is FirstEnergy exposed to extra risk or cost?

A: No. FirstEnergy's rationale for denying late shoppers the 65% of RSC that would be included in the shopping charge for early shoppers seems to be that

FirstEnergy Solutions must determine how its generation will be committed for 2006, and late shoppers would require some last-minute adjustments in the portfolio.[20] Even if that rationale applied to late shoppers, FirstEnergy would have plenty of time to plan for customers whose contracts ended after 2006 or 2007.

D. The Wholesale "Competitive Test"

Q: Does the Plan include any provisions to ensure that the generation prices charged by FirstEnergy will not exceed competitive market prices?

A: Mr. Alexander (at 21) claims that the Plan "ensures that customers pay the lowest available prices," by "market-based auctions that may be conducted annually." This "competitive bidding process" is described in Section IV of the Plan.[21]

Q: Would the competitive test proposed in the Plan effectively limit First-Energy's ability to charge generation prices that are much greater than market prices?

A: No. FirstEnergy has built such fatal pricing flaws and other non-price obstacles into the bid process that the process would almost certainly fail.

Perhaps most importantly, the Application states that the Plan's competitive test will measure bids against generation prices much lower than those

[20]FirstEnergy does not offer any clear justification of this feature of the Plan, but this seems to be Mr. Alexander's meaning at pages 25–26 of his direct.

[21]This provision is distinct from two other types of competition FirstEnergy discusses. The competitive bidding process described in Exhibit 1 to the Application would be an alternative to the Plan, not part of the Plan. The competition between the POLR supplier and the offers of aggregators and suppliers is a third type of competition that is anticipated by the Plan, but would be strongly discouraged by its provisions.

that FirstEnergy would be charging. While FirstEnergy would be charging *g* + RSC, suppliers would bid against *g* alone. At Section IV Paragraph 1, the Plan specifies that the competitive bids "shall be measured against the generation charge set forth in Section II Paragraph 1" (Application Exhibit 2 at 9–10). Section II Paragraph 1 defines the "generation charge" to be equal to "'little g' in effect as of December 31, 2005" (Ibid. at 6). I initially had difficulty believing that FirstEnergy was actually proposing to force competitive POLR suppliers to bid against a generation price much lower than FirstEnergy would be charging, but FirstEnergy confirms in GMEC-9-1 that it intends exactly that.[22]

The Plan also specifies that acceptance of the competitive bid by the Commission would terminate the Plan, and hence collection of the RSC from customers on POLR, as well as from shopping customers. FirstEnergy confirms its intent in GMEC-9-2.

Not only would the competitive bidders need to bid less than *g,* they would be bidding a fixed value of *g,* while FirstEnergy's *g* would be subject to upward adjustment if various components of FirstEnergy's costs increase (even if other components decrease). Thus, while competitors would have to bid less than the current value of *g*, FirstEnergy would be paid the current *g*, plus upward adjustments, plus RSC.

Q: How much different could the bids be from the price FirstEnergy would be paid?

A: Based on the *g* and GTC values underlying Mr. Alexander's estimate of *g* and RSC, provided in GMEC-10-1, the system-wide average *g* would be 2.94¢/kWh, and RSC would be 1.73¢/kWh at December 31, 2005. If the Commission

[22]FirstEnergy could also be deferring some costs related to *g,* but FirstEnergy claims that those deferred costs would somehow be added to *g* for the competitive bid.

wanted to hold an auction for competitive supply for 2007, that auction would be held an auction late in 2005, to allow FirstEnergy one year's notice before the competitive suppliers took over on January 1, 2007. In order to win the auction, the bidders would have to offer POLR services for 2007 for less than 2.94¢/kWh.

FirstEnergy, on the other hand, would be entitled to charge at least 4.66¢/kWh, almost 60% more than the competitors. FirstEnergy's generation charge would likely be somewhat higher, due to upward adjustments in *g* for 2006 and 2007. Those upward adjustments could be as much as 15% annually for increases in fuel costs since 2002, as well as environmental and nuclear costs over an unspecified base, and more for regulatory costs and taxes. If *g* increases 15% in each of 2006 and 2007, it would grow to nearly 3.9¢, and FirstEnergy's average generation charge would exceed 5.6¢/kWh, nearly twice the price the competitors could bid.

In addition, while FirstEnergy would receive generation payments from customers who take their power supply from competitive suppliers, while any replacement POLR supplier would not, since the RSC would be terminated.

Q: What are the non-price obstacles to effective competitive bidding for POLR service in the Plan?

A: The Plan would excessively constrain the Commission's design of competitive bidding, usurping PUCO authority and reducing the likelihood of the Commission obtaining service at the lowest possible cost. For example, Section IV would require that the bid process

- be developed by FirstEnergy, the Staff, the OCC and "other interested parties that do not oppose the adoption of this Plan," excluding any other parties critical of FirstEnergy's approach,[23]
- not be undertaken "more often than annually,"
- must be for "the totality of the loads within the respective service territories of the Companies" and "sufficient to meet the supply requirements for all customer classes of all of the companies,"
- "shall be for a calendar year of service,"
- "shall cover a period commencing at least 12 months after the Commission's determination as to whether or not to accept the results of such bidding process."

The terms of the Plan would prohibit the Commission from initiating a new solicitation less than a year after an unsuccessful solicitation; bidding out part of the POLR requirement and leaving the rest with FirstEnergy; setting a service period that started any time but January 1, or ended any time but December 31, or continued for more than a year; or accepting a bid for service less than a year into the future.

All of these features are common in other states' competitive solicitations, and their prohibition in the Plan might well prevent the Commission from replacing FirstEnergy with a lower-priced POLR supplier. In particular, if the regional power supply is not sufficient to replace all of FirstEnergy's service, the all-or-nothing structure of the bidding may protect FirstEnergy from having to match market prices, and allow FirstEnergy to charge well above market. Mr. Alexander acknowledges that it may not be physically possible for another

[23]The Commission would have some discretion to direct FirstEnergy to accept other parties in the process (§IV.2).

supplier to supply all the load of the FirstEnergy Ohio utilities (Tr. 1/28/04 at 423).

Q: Can the Commission rely on the competitive test under the Plan to ensure that FirstEnergy's generation costs for POLR will reflect the regional market?

A: No. Section IV of the Plan would need to be extensively reworked to make it at all useful. The competitive test for POLR service is not a suitable substitute for a plan that allows for effective competition in the form of customer shopping. Especially in the absence of a workable competitive test, the interests of rate-payers will be better served by the Commission ensuring that shopping credits are set high enough to allow competition and commensurate with the prices FirstEnergy would be charging for generation.

V. Comments on the Staff Testimony

Q: Have you reviewed the Staff testimony in this proceeding?

A: Yes. I have particularly paid attention to the testimony of Mr. Cahaan, on the RSP. I agree with Mr. Cahaan regarding many of the problems with First-Energy's proposed RSP, and with some of his proposed solutions. Specifically, we agree that

- FirstEnergy proposes to retain too much of the generation charge for early shoppers (Cahaan at 9).
- Customers who are served by competitive suppliers and do not desire the option of returning to regulated rates should be exempt from any First-Energy charges for guaranteeing the availability of POLR service (10).
- FirstEnergy's right to terminate the Plan at no notice "negates the primary purpose of the Plan" and should be rejected (8).

- FirstEnergy should not be allowed to defer generation costs associated with POLR service (10–11).
- The total annual increase in g should be limited to 15%, including taxes and regulatory costs (11).
- The competitive market is not sufficiently mature (4–6).

Q: Are there areas in which the Staff's position requires further development?

A: Yes. The Staff does not follow its comments regarding the immaturity of the competitive market to their logical conclusion: that an immature competitive market argues for maintaining or increasing shopping credits, rather than decreasing them, if the Commission's objective—"encouraging competitive markets to further develop" (Case No. 02-2779-EL-ATA Opinion and Order of 9/2/2003 at 29; Entry in Case No. 03-1461-EL-UNC at 4 (September 23 2003))—is to be achieved.

Most importantly, the Staff does not follow its position on the shopping credit to its logical conclusion, and does not sufficiently question some critical assertions by FirstEnergy. Mr. Cahaan points out that "the benefit to the customers and the risks to the Companies [of the POLR guarantee] decline with time," so the charge of 35% of RSC should decline with time. I assume that Mr. Cahaan means that the charge should start at 35% at January 2006 and decline to zero by July 2008, at which point the Plan would no longer offer any fixed-price guarantee. While Mr. Cahaan's suggestion is a small improvement over FirstEnergy's proposal, it does not address the following related issues:

- If FirstEnergy is allowed to increase *g* by 15% (or, in FirstEnergy's proposal, by much more), the fixed-price POLR guarantee becomes a variable-price guarantee after January 1 of the next year. After July 1 of each year, shopping customers actually have no fixed-priced guarantee, since they

would pay market prices for the first six months following return to POLR service. The value of the POLR guarantee is thus much reduced.

- If FirstEnergy retains the right to terminate the Plan at any January 1, the fixed-price POLR guarantee disappears at the beginning of the next year. After each July 1, a returning customer would face six months at market prices, followed by possible termination of the Plan, leaving the POLR guarantee with zero value.
- FirstEnergy has offered no justification for charging 35% of RSC for the POLR guarantee, rather than 10% or 5%.
- FirstEnergy has offered no justification for charging a percentage of RSC for the POLR guarantee, rather than the same charge for each class and each company. For example, FirstEnergy would charge 30% more for the POLR guarantee for Ohio Edison's residential water-heating than for Cleveland Electric Illuminating's residential water-heating, and 20% more for the POLR guarantee for Ohio Edison's residential water-heating than for the same company's general residential service. These differences would be inconsistent with the statutory requirement for non-discriminatory rates in O.R.C. Sec. 4928.14(A).

Perhaps the most troubling problems are associated with Mr. Cahaan's statement (at 9) that the Staff "agrees that the 12/31/04 choice date is necessary and reasonable, since FirstEnergy needs time to determine how it is to commit its generation and fulfill its responsibilities." The Staff correctly recognizes that FirstEnergy's intention is to prohibit choice from January 2005–December 2008, rather than track some change in cost structures. But the Staff does not deal with a number of problems with this aspect of FirstEnergy's proposal.

- No similar cut-off on choice is imposed in other restructured jurisdictions. Neither FirstEnergy nor the Staff provide any evidence that a "choice date is necessary and reasonable" in FirstEnergy's Ohio territory.
- FirstEnergy believes that other POLR suppliers could make their supply decisions and commitments within five months of being selected to provide POLR. Neither FirstEnergy nor the Staff provides any evidence that FirstEnergy needs more time than other suppliers. Yet the RSP would require customers to give notice before January 1, 2005 for service in 2006, one year in advance.
- Even if FirstEnergy needed a year to prepare for providing POLR service starting in January 2006, FirstEnergy has not explained why it would need two years (all of 2005 and 2006) to prepare for providing POLR service starting in January 2007 and three years (2005, 2006, and 2007) to prepare for providing POLR service starting in January 2008. The reasoning advanced by FirstEnergy and the Staff suggests that no penalty should be applied to any customer taking competitive service, so long as FirstEnergy has one year (or more appropriately, five months) notice. Thus, if a customer has a competitive-supply contract in place by the end of 2004 that covers calendar 2006, that customer would not be charged the punitive RSC rate for 2006. So long as the customer has a contract in place by December 2005 covering 2007, it would not pay the punitive RSC rate for 2007, either.

Q: Does the Staff address all the important issues in this proceeding?

A: No. FirstEnergy proposes that the market prices at which it would provide service for the first six months following a customer's return would be "the highest purchased power costs incurred by any affiliate of FirstEnergy to serve

any of its customers during the applicable month" (Application, Section II.2(b)). Mr. Cahaan (at 9–10) appears to assume that FirstEnergy would actually charge the incremental cost of power for the customer's load in northern Ohio, rather than the higher prices that would result from a literal reading of FirstEnergy's language (which I discuss above at 21).

The Staff also does not describe the flaws in the competitive test, which I describe in Section IV.D.

VI. Recommendations

Q: What are your recommendations?

A: The Commission should substantially restructure the RSP to achieve a reasonable balance of the Commission's three objectives of rate certainty, financial stability for the electric distribution utilities, and the further development of competition.

Specifically, the Commission should set the 2006–2008 shopping credits to approximate market prices. In the absence of a direct market test, those prices should be set at the total generation charge *(g* + RSC) as proposed by FirstEnergy, but not to average less than the customer-class shopping credits that the Commission approves for 2005, from the Case 99-1212 Stipulation.

Following the Commission's reasoning regarding the 2004 shopping credits, I recommend that the 2005 shopping credits should be set at the 2005 levels specified in Supplemental Attachment 3 to the Case 99-1212 Stipulation.

In any case, the Commission should not allow FirstEnergy to charge more for generation services than the shopping credit avoided by customers who select other suppliers, regardless of when a customer commits to a competitive supplier. FirstEnergy should not be allowed to penalize customers for switching

to a competitive supplier after arbitrary cut-off dates, or for failure to have a contract for a multiple-year term meeting arbitrary FirstEnergy requirements.

Any adjustments in the shopping credit should be tied to external cost indices (e.g., total generation retirements in ECAR, coal-price indices, cost of allowances) rather than to costs that are specific to FirstEnergy. Costs related to POLR service should be included in current rates and in the shopping credits, rather than deferred for future collection.

The Commission should reject FirstEnergy's request that it be allowed a unilateral right to terminate the RSP, or to increase security requirements beyond those it has accepted for 2001–2004.

The Commission should reserve to itself the right to design and operate the auctions that would determine whether FirstEnergy should be replaced as the POLR supplier. The evaluation of bids in those auctions should consider the entire generation charge, and not just the *g* component of that charge.

Q: Does this conclude your testimony?

A: Yes.