File

(R)

CG&E EXHIBIT ______

BEFORE

THE PUBLIC UTILITIES COMMISSION OF OHIO

IN THE MATTER OF THE APPLICATION OF THE CINCINNATI GAS & ELECTRIC COMPANY FOR APPROVAL OF ITS TRANSITION PLAN AND FOR AUTHORIZATION TO COLLECT TRANSITION REVENUES.	)	CASE NO. 99-1658-EL-ETP

SUPPLEMENTAL TESTIMONY OF

COLIN C. BLAYDON

ON BEHALF OF

THE CINCINNATI GAS & ELECTRIC COMPANY

May 1, 2000

SUPPLEMENTAL TESTIMONY OF

COLIN C. BLAYDON

SUPPLEMENTAL TESTIMONY OF COLIN C. BLAYDON

I. INTRODUCTION

Q. Please state your name, occupation and business address.

A. My name is Colin C. Blaydon. I am a Senior Advisor of PHB Hagler Bailly, Inc. (PHB), an economic and management consulting firm that provides clients with strategy analysis, policy research, expert testimony and litigation support. My business address is 1776 Eye Street, N.W., Washington, DC 20006.

Q. Are you the same Colin C. Blaydon who drafted the Direct Testimony filed on behalf of Cincinnati Gas & Electric Company (CG&E) in this proceeding?

A. Yes. My qualifications are discussed in my Direct Testimony.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to respond to the objections raised by Intervenors relating to the cost of capital used by CG&E's expert witnesses in their Transition Cost analyses and the appropriateness of using a risk adjusted discount rate.

Q. **Intervenor Shell Energy Services Company has objected to the use of a risk-adjusted discount rate, stating that CG&E should be required to compute transition costs using a risk-free discount rate (Shell Energy Objections, pp. 59-60). Do you agree?**

A. No. Even under a regulatory environment, CG&E's generating assets would be exposed to business and financial risk, as those terms are defined in my Direct Testimony. Historically, the Commission has recognized these risks and has allowed CG&E a regulated return far in excess of a risk-free return. Moreover, with the introduction of a competitive market for electricity in Ohio, CG&E's generating assets will be faced with even greater risks than those faced in its formerly regulated environment.

Q. **Intervenor AK Steel Corporation argues that CG&E's discount rate used for present value purposes ignores the utility's historical cost of capital, stating that CG&E should employ either its own cost-of-capital or a market rate with a stranded benefit adjustment to reflect the lower cost of capital actually incurred by the utility. (AK Steel Objections No. 11, p. 5 and 27, p. 8) Do you agree?**

A. No. CG&E's historical cost of capital reflects the regulated environment in which it has operated in the past. As discussed in my Direct Testimony, the business risks facing regulated IOUs are significantly lower than the risks facing unregulated generators such as IPPs and MPPs. CG&E's Transition Cost analysis is forward looking, i.e., the value of its assets are determined by events occurring over the next 20 years or more. Since CG&E's generating assets will receive future revenues that are determined in a competitive market rather than regulated market, the market risks facing these assets are comparable to those facing merchant power plants.

Q. The Kroger Company argues that CG&E's cost of capital assumption ignores the availability of low cost pollution control debt for new environmental capital expenditures (Kroger Objection, p. 15). Please respond.

A. While it is true that CG&E's historical cost of capital includes some amount of pollution control debt (which is mostly short-term debt constituting less than 15% of total company debt), the relevant cost of capital for determining the value of CG&E's generating assets in a competitive market is not its historical cost of capital, but rather, the future cost of raising funds in the capital markets that a merchant plant will face in the competitive market for electricity. My analysis of CG&E's assumption relating to the cost of capital, particularly the cost of debt component, is consistent with the overall debt costs obtained by several recent merchant plant financings, which also are required to have emissions control equipment to meet environmental regulations.

Q. The Ohio Consumers' Counsel (OCC) argues that CG&E uses a discount rate for a hypothetical merchant power plant that is too high; OCC further states that such a discount rate understates the market value of CG&E's generating assets (OCC Objection No. 10, p. 5). Do you agree?

A. No. The empirical analyses presented in my Direct Testimony demonstrates that the 9.2% discount rate used in valuing the CG&E generating assets is at the lower end of the range that represents reasonable estimates of the after-tax weighted cost of capital for merchant power plants. Recall that these estimates ranged from 8.8% to about 13%, with an average point estimate of about 11%.

Importantly, as discussed in my Direct Testimony, the discount rate used in valuing the cash flows associated with CG&E's generating assets should be consistent with the cost of capital assumption used in forecasting electricity prices, since the CG&E generating assets will be competing in the same electricity markets as the generating assets assumed to come on-line in the market price forecast analysis. Therefore, it is inappropriate to use a lower discount rate for determining the present value of the cash flows associated with CG&E's generating assets while, at the same time, using a higher cost of capital to determine the market price forecasts which are used in developing these cash flows. If a lower cost of capital assumption were to be used for both the discount rate and the market price forecast, any increase in the market value of the CG&E generating asset caused by a lower discount rate would be correspondingly decreased by a lower market price forecast.

II. SUMMARY AND CONCLUSIONS

Q. Please summarize your response to Intervenor objections relating to the cost of capital used in CG&E's Transition Cost analyses?

A. Looking forward, since CG&E's generating assets will be operating in a competitive environment, the appropriate discount rate to use in valuing the cash flows from these assets is one that reflects the riskiness of these cash flows, which will be similar to the risks facing MPPs. My empirical analyses of the after-tax WACC for MPPs demonstrates that the 9.2% discount rate used by CG&E's witnesses is a reasonable, and probably, conservative estimate of the cost of capital that will be required to attract investors in this new competitive environment.

Q. Does this conclude your supplemental testimony?

A. Yes, it does.