**OCC EXHIBIT \_\_\_\_\_\_\_**

**BEFORE**

**THE PUBLIC UTILITIES COMMISSION OF OHIO**

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| --- | --- | --- |
| In the Matter of the Application of The Dayton Power and Light Company To Establish a Fuel Rider. | )  )  )  ) | Case No. 11-5730-EL-FAC |

**DIRECT TESTIMONY**

**OF**

**GREGORY SLONE**

**On behalf of**

**The Office of The Ohio Consumers’ Counsel**

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***October 4, 2012***

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# I. INTRODUCTION

***Q1. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND POSITION.***

***A1.*** My name is Gregory Slone. My business address is 10 West Broad Street, Suite 1800, Columbus, Ohio 43215-3485. I am employed by the Office of the Ohio Consumers’ Counsel (“OCC” or “Consumers’ Counsel”) as a Senior Energy Analyst.

***Q2. PLEASE BRIEFLY SUMMARIZE YOUR EDUCATIONAL AND PROFESSIONAL EXPERIENCE?***

***A2.*** I joined the OCC in May 2010 as a Senior Energy Analyst. Prior to joining the OCC, I served as vice president of generation services for American Municipal Power, Inc. (“AMP”), where I was responsible for the daily operations of the company’s electric generating plants, which included negotiating all the commodity contracts for purchasing and selling coal, natural gas and emission allowances. I also developed and directed AMP’s natural gas and electric aggregation consulting business. As General Manager of the aggregation business, I negotiated consulting services contracts with more than forty municipalities throughout Ohio. These services included negotiating the price, terms and conditions for gas and electric supply with the retail gas and electric service providers.

Prior to AMP, I worked for many years for Columbia Gas of Ohio, Inc. (“Columbia”), serving in a number of sales and marketing positions, including director of sales for the Company. During my employment at Columbia, I was responsible for interfacing with customers and retail natural gas marketers on issues related to gas costs, gas supply, and rates. In addition, I negotiated special contracts with major industrial accounts in response to competitive market issues.

I received my bachelor’s degree in civil engineering from The Ohio State University in 1977, and was certified as a chartered industrial gas consultant by the Gas Technology Institute in Chicago, Illinois in 1984.

***Q3.******WHAT ARE YOUR RESPONSIBILITIES AS A SENIOR ENERGY ANALYST?***

***A3.*** My duties include research, investigation and analysis of electric and natural gas utility filings at the state and federal levels, participation in special projects, and assistance in policy development and implementation. Specifically, I provide policy and technical analysis on both natural gas and electric utility filings with the Public Utilities Commission of Ohio (“PUCO” or “the Commission”), including Gas Cost Recovery Audits, Fuel Adjustment Clause Audits, Long Term Forecast Reports, Infrastructure Replacement Programs and Rate Cases.

***Q4. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY OR TESTIFIED BEFORE THIS COMMISSION?***

***A4.*** Yes, I have submitted testimony and testified in connection with two Purchased Gas Adjustment cases, *In the Matter of Northeast Ohio’s and Orwell’s Purchased Gas Adjustment Clauses*, Case No. 10-209-GA-GCR and Case No. 10-212-GA-GCR. In addition, I submitted testimony and testified in Columbia Gas of Ohio’s application to implement a wholesale auction, *In the Matter of the Application of Columbia Gas of Ohio, Inc. for Approval of a General Exemption of Certain Natural Gas Commodity Sales Services or Ancillary Services*, Case No. 08-1344-GA-EXM.

***Q5. WHAT DOCUMENTS HAVE YOU REVIEWED IN THE PREPARATION OF YOUR TESTIMONY?***

***A5.***  I have reviewed the 2011 Management/Performance and Financial Audits of the Fuel and Purchased Power Rider of the Company in Case No. 11-5730-EL-FAC (“the 2011 Audit”), along with the Company’s responses to certain discovery in this case. I reviewed the Application of the Dayton Power and Light Company to Establish a Fuel Rider and the 2010 Management/Performance and Financial Audits of the Fuel and Purchased Power Rider of the Company from Case No. 09-1012-EL-FAC (“the 2010 Audit”). In addition I reviewed certain relevant sections of the Application and the Stipulation and Recommendation in the Application of the Dayton Power and Light Company for Approval of Its Electric Security Plan from Case No. 08-1094-EL-SSO (“ESP Stipulation”).

# II. PURPOSE OF TESTIMONY

***Q6. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?***

***A6.*** The purpose of my testimony in this proceeding is to 1) evaluate the prudence of the Company’s coal trading and optimization efforts and analyze whether such efforts result in least cost fuel and purchased power being allocated to retail customers, and 2) recommend refunds related to those trading and optimization activities not found to be prudent and not in keeping with least cost principles. Specifically, I recommend the Company’s current fuel optimization program practices, including those of utilizing the replacement of NYMEX coal with lower quality and higher sulfur coal, be discontinued. And I recommend that a refund of $7.3 million be credited back to the Fuel and Purchased Power Rider (“FUEL Rider”) for improper fuel optimization program activities. This refund will provide a direct benefit to residential customers of DP&L who continue to take service from the utility. The $7.3 million represents the total optimization proceeds identified by the Company in response to OCC discovery[[1]](#footnote-1) associated with twelve optimizations for 2011 that were reviewed in the audit in this case and charged to the FUEL Rider. In addition I recommend that 25% of the jurisdictional coal sales gains for 2011 be netted against the fuel and purchased power costs for 2011, which is consistent with the ESP Stipulation, and will benefit customers.

# III. FUEL AND PURCHASE POWER RIDER

***Q7. CAN AN ELECTRIC DISTRIBUTION UTILITY COLLECT FUEL AND PURCHASED POWER COSTS UNDER A STANDARD SERVICE OFFER?***

***A7.*** Yes. It is my understanding that there are provisions within the Ohio Revised Code that permit an electric distribution utility to collect the costs of fuel and purchased power used to generate electricity supplied under a standard service offer. However, the costs of fuel and purchased power must be shown by the utility to be “prudently incurred.”[[2]](#footnote-2)

***Q8.*** ***WHAT IS THE ORIGIN OF DP&L’s CURRENT FUEL AND PURCHASED POWER RIDER?***

***A8.*** In DP&L’s first electric security plan (“ESP”) proceeding, Case No. 08-1094-EL-SSO, a Stipulation was reached to resolve all of the issues. Specifically, DP&L agreed to implement a bypassable fuel recovery rider.[[3]](#footnote-3) DP&L’s rider was to be implemented to collect retail fuel and purchased power costs, “based on least cost fuel and purchased power being allocated to retail customers.”[[4]](#footnote-4) The Stipulation set forth the formula for the rider whereby jurisdictional emission allowance proceeds and twenty-five percent of jurisdictional coal gains would be netted against the fuel and purchased power costs. The PUCO approved the Stipulation and Recommendation on June 24, 2009, which extended DP&L’s rate plan through December 31, 2012.

On October 30, 2009, the Company submitted an application to implement the bypassable FUEL Rider, which was docketed as Case No. 09-1012-EL-UNC. Rates were to become effective January 1, 2010.[[5]](#footnote-5)

In that same docket, an initial audit was conducted for 2010 (for the period of January 1, 2010, through December 31, 2010) and filed on April 29, 2011, in Case No. 09-1012-EL-FAC.

***Q9. WHAT WAS THE OUTCOME OF THE INITIAL 2010 AUDIT OF DP&L’S FUEL RIDER?***

***A9.*** In the initial audit, the Auditor made a number of recommendations directed at DP&L’s FUEL Rider. Subsequently, a stipulation (“2010 Audit Stipulation”) was reached in the proceeding encompassing numerous findings by the Auditor. The Company agreed, among other things, to credit certain dollars to DP&L’s FUEL Rider, revise certain operating procedures for coal procurement, and continue to refine the “optimization” policies surrounding the purchasing and trading of coal.[[6]](#footnote-6)

The optimization policies were the means through which the coal sale gains referred to in the SSO Stipulation were to be netted against fuel and purchased power costs collected from retail customers. The PUCO approved the Stipulation in its entirety on June 24, 2009.

***Q10. DID THE 2011 AUDIT, FILED IN THIS CASE ON APRIL 27, 2012, ADDRESS THE PROVISIONS OF THE 2010 AUDIT STIPULATION?***

***A10.*** Yes.

***Q11. DID THE AUDITOR FIND THAT THE COMPANY COMPLIED WITH THE PROVISIONS OF THE 2010 AUDIT STIPULATION?***

***A11.*** No. While the majority of the provisions included in the 2010 Fuel Stipulation were satisfactorily addressed and/or complied with by the Company, the Auditor found that the Company had failed to demonstrate the benefits of optimization to jurisdictional customers.[[7]](#footnote-7)

***Q12. DID THE AUDITOR MAKE ANY ADDITIONAL FINDINGS IN THE 2011 AUDIT RELATED TO THE COMPANY’S OPTIMIZATION ACTIVITIES?***

***A12.*** Yes, the Auditor made several findings in the 2011 Audit related to coal optimizations, including:

1. DP&L failed to disclose three 2010 optimizations that should have been disclosed during the prior audit period,
2. DP&L disclosed an additional nine optimizations it completed in 2011, and
3. DP&L improved its documentation of the optimizations, but failed to quantify the actual benefit to jurisdictional customers as requested by the Auditor.[[8]](#footnote-8)

***Q13. DID THE AUDITOR MAKE ANY RECOMMENDATIONS REGARDING THE COMPANY’S OPTIMIZATION ACTIVITIES BASED ON THE FINDINGS?***

***A13.*** Yes. The Auditor recommended the FUEL Rider should be adjusted to delete the optimization values associated with optimization 2011-A and 2011-E. In addition, the Auditor recommended that DP&L should revise its optimization calculations for the remaining ten optimizations using a more rigorous and documented analytical approach. And finally, the Auditor recommended that the Company should expand its optimization documentation to include the gains/losses on the underlying hedges.[[9]](#footnote-9)

***Q14.*** ***DO YOU HAVE ANY CONCERNS IN REGARD TO CONTINUING THE COMPANY’S OPTIMIZATION ACTIVITIES?***

***A14.*** Yes.

***Q15.*** ***WHY IS CONTINUING THE CURRENT OPTIMIZATION ACTIVITIES A CONCERN?***

***A15.*** As discussed, the FUEL Rider can only collect from customers the costs of fuel and purchased power that have been shown by the utility to be “prudently incurred.” Additionally, as part of the Stipulation and Recommendation that established the FUEL Rider (Case No. 08-1094-EL-SSO), the parties agreed that the FUEL Rider would be based on “least cost fuel and purchased power being allocated to retail customers.”[[10]](#footnote-10) To calculate the FUEL Rider, the Stipulating parties agreed that twenty-five percent of jurisdictional coal sales gains from DP&L’s optimization efforts would be netted against the fuel and purchased power costs for retail customers.[[11]](#footnote-11) The Company would be permitted to retain the remaining seventy-five percent of the gains.[[12]](#footnote-12)

However, in both of the Company’s 2010 and 2011 Management/Performance and Financial Audits of the Fuel and Purchased Power Rider, the Auditors pointed out significant problems with the Company’s fuel optimization process. Most notably, in both Audit Reports the Auditor found that DP&L had not demonstrated the benefits of the optimizations to jurisdictional customers.[[13]](#footnote-13)

***Q16. WHY ARE THE AUDITORS’ FINDINGS SIGNIFICANT?***

***A16.*** The findings of the Auditor are significant because they show that DP&L has not proven that the costs of the optimization benefits charged to the FUEL Rider are prudently incurred costs.[[14]](#footnote-14) Neither has DP&L shown that the FUEL Rider is based on least cost fuel and purchased power being allocated to retail customers. This means that the “optimization benefits” costs cannot be collected from customers, because they do not comply with the statute[[15]](#footnote-15)and because they violate the Stipulations.[[16]](#footnote-16)

Without a clear demonstration that the optimization transaction results in a net decrease of cost to the retail customer, DP&L should not be allowed to continue to collect seventy-five percent of the imputed optimization “benefits (or gains)” by imposing a higher (i.e. more than what DP&L actually spent in coal procurement) fuel cost rider on jurisdictional customers.

# IV. DP&L’S CALCULATION OF FUEL OPTIMIZATION BENEFITS

***Q17. WHAT IS YOUR UNDERSTANDING OF THE TERM “FUEL OPTIMIZATION” AS CONCEIVED BY DP&L?***

***A17.*** As described by Energy Ventures Analysis, Inc. (“EVA”), the Auditor who performed both the 2010 and 2011 audits of the fuel and purchased power rider, optimizations are transactions involving fuel or purchased power which reduce costs.[[17]](#footnote-17) The Company does not define “fuel optimization” quite so succinctly, but when referring to its optimization objectives and practices, it states “DP&L will make coal sales at either a nominal gain or nominal loss that will be offset by a replacement purchase at a lower price.”[[18]](#footnote-18)

***Q18.*** ***ARE THE COMPANY’S “FUEL OPTIMIZATION” EFFORTS CONSISTENT WITH YOUR UNDERSTANDING OF THE PROCESS AS DEFINED BY THE AUDITOR AND DESCRIBED BY DP&L IN ITS APPLICATION FOR A FUEL RIDER?***

***A18.*** No. My understanding from reviewing the Company’s Application for a fuel rider in Case No. 09-1012-EL-FAC, and the Auditor’s subsequent comments related to optimizations in Case No. 11-5730-EL-FAC, is that no optimization transaction would take place unless the net effect of the transaction resulted in a net decrease of costs to retail customers.[[19]](#footnote-19) My understanding is consistent with the statutory requirement that the fuel costs be prudently incurred[[20]](#footnote-20) and made on a least cost basis, consistent with the Stipulations. Unfortunately, the Company’s optimization efforts usually have had the effect of **increasing** costs to customers, as demonstrated in Exhibit GS-1.

***Q19. DID THE AUDITOR FIND THAT THE COMPANY’S ACTIVITIES MEET THE INTENT OF THE FUEL OPTIMIZATION PROGRAM AS OUTLINED IN THE 2009 ESP STIPULATION OR THE 2009 APPLICATION TO ESTABLISH A FUEL RIDER?***

***A19.*** No. In the 2011 Audit Report, EVA stated that it did not believe that DP&L’s approach to optimization was consistent with the intent of the ESP Stipulation.[[21]](#footnote-21) The Stipulation language in Case No. 08-1094-EL-SSO states that “DP&L will implement a bypassable fuel recovery rider to recover retail fuel and purchased power costs, based on least cost fuel and purchased power being allocated to retail customers. To calculate the rider, jurisdictional emission allowance proceeds and twenty-five percent of jurisdictional coal sales gains will be netted against the fuel and purchased power costs”[[22]](#footnote-22) However, the Company’s calculation includes a fuel optimization transaction not only on the initial coal sales gains, but also on the subsequent replacement coal price. This calculation was not contemplated in the ESP Stipulation.

In addition, in the 2009 Application for a fuel rider the Company stated that “DP&L will make coal sales at either a nominal gain or nominal loss that will be offset by a replacement purchase at a lower price. No optimization transaction will take place unless the net effect of the transaction results in a net decrease of costs to the retail ratepayer.”[[23]](#footnote-23) But its 2011 Audit review of optimizations EVA stated that “DP&L prepared a one to two page description of each optimization which provide the reason for the optimization and a summary of what was sold (tons and price) and what was purchased (tons and price). **It did not, however, provide the full accounting of the optimization and, hence, did not demonstrate the benefits of the optimization to jurisdictional customers**.”[[24]](#footnote-24)

***Q20.*** ***HOW DOES THE COMPANY CALCULATE AN OPTIMIZATION BENEFIT?***

***A20.*** An illustrative optimization benefit calculation is shown in Exhibit GS-1, based on information provided by EVA in the 2010 Audit Report, which was derived from DP&L’s accounting procedures to credit optimization benefits to jurisdictional customers.[[25]](#footnote-25) Exhibit GS-1 shows three separate calculations used by the Company to value the optimization transactions and the benefit from fuel optimization. The first calculation determines the gain on the sale of coal. The second calculation compares the sale price of the NYMEX coal to the purchase price of the replacement coal. The third calculation is used to determine the additional fuel costs be added to the fuel rider and collected from the jurisdictional customers.

***Q21.*** ***PLEASE EXPLAIN THE FIRST CALCULATION***.

***A21.*** The first calculation illustrates the gain (profit) made on the sale of two NYMEX coal contracts, NYMEX A and NYMEX B. In this scenario, the coal was purchased at two different times and at different prices. NYMEX A was purchased at time A for $61.75/ton and NYMEX B was purchased at time B for $63.75/ton. Both coal purchases are later sold at time C for $70.50/ton. In the first calculation, the gain on the sale of NYMEX A coal is $8.75/ton and the gain on the sale of NYMEX B coal is $6.75/ton.

***Q22. WHAT DOES THE SECOND CALCULATION ILLUSTRATE?***

***A22.*** The second calculation shows how the optimization benefit is developed. Continuing from the first calculation, NYMEX A coal and NYMEX B coal are sold at time C for $70.50/ton. In addition to this sale, replacement coal is also purchased at time C to offset the total volume of NYMEX A coal and NYMEX B coal sold. However, the replacement coal in this example is not a NYMEX coal, but an Illinois Basin Coal, which is different than NYMEX coal, in part because it has a higher sulfur level than the NYMEX coal and normally a lower Btu/lb. heating value. The price differential between NYMEX coal and Illinois Basin coal can vary, but for similar Btu levels, the Illinois Basin coal generally trades at a lower price than NYMEX coal, because of the higher sulfur content of the Illinois Basin coal.

In this example, at time C, the lower sulfur NYMEX coal sells for $70.50/ton, while the higher sulfur Illinois Basin coal is purchased for $46.75/ton. However, the added cost to transport and burn the higher sulfur Illinois Basin coal must be added to the purchase price of the replacement coal in order to have an appropriate comparison. I have estimated this additional cost to be $7.00/ton. I started with the Auditor’s estimate of $8.00/ton in the 2010 Audit[[26]](#footnote-26) and reduced it slightly to account for more competitive barging costs in today’s market, due to a weak coal market and high coal inventory levels for most generators.[[27]](#footnote-27) When I add the $7.00/ton adjustment to the actual cost of the Illinois Basin coal the total replacement coal cost is $53.75/ton ($46.75/ton + $7.00/ton = $53.75/ton). In this example, the Company would calculate the optimization benefit at $16.75/ton by subtracting the cost of the replacement coal from the sale price of the NYMEX coal ($70.50/ton - $53.75/ton). Then, to calculate its portion of the optimization benefit, the Company takes 75% of the $16.75/ton, which equates to $12.56/ton.

***Q23. PLEASE EXPLAIN THE THIRD CALCULATION.***

***A23.*** The third calculation shows the impact of the optimization to the Fuel Rider and to customers. In this calculation the total replacement coal cost of $53.75/ton developed in the second calculation is used to determine the charge to the Fuel Rider. First, the replacement coal cost is reduced by the gain on the NYMEX coal sale, which was $8.75/ton for NYMEX A ($53.75/ton -$8.75/ton = $45.00/ton) and $6.75/ton for NYMEX B ($53.75/ton - $6.75/ton = $47.00/ton). Finally, the Company’s optimization benefit of $12.56/ton is added to the remaining coal cost for both scenarios. The result is a net charge to the Fuel Rider of $57.56/ton for NYMEX A and $59.56/ton for NYMEX B.

***Q24. IS THE CALCULATION OF THE “BENEFIT” FROM FUEL OPTIMIZATION APPROPRIATE FOR INCLUSION IN THE FUEL RIDER?***

***A24.*** No. The calculation of fuel optimization benefits is inappropriate for the following reasons:

1. The Company is using an incorrect accounting process to calculate the optimization benefit to the FUEL Rider. The optimization benefit should include twenty-five percent of jurisdictional coal sales gains netted against the FUEL Rider costs. Instead, DP&L is calculating an optimization charge based on the difference between the sale price of coal and the replacement coal cost of a lower quality coal.

2. Over time, the Company was able to increase the amount of high sulfur coal it was able to burn in its scrubbed generating facilities,[[28]](#footnote-28) but it continued to purchase more expensive NYMEX coal because it is a more liquid product to resell back into the market should the price for NYMEX coal increase. In other words, the initial purchase of NYMEX coal, from which the optimization calculations are dependent, is not a prudent purchase and is not the least cost option whenever the company had the ability to burn higher sulfur coal.

3. The Company is creating an artificial “optimization benefit” by purchasing and reselling NYMEX coal and replacing it with lower priced Illinois Basin coal that could have been purchased in the first place, which ultimately increases the charge to the FUEL Rider. This increase creates additional costs for customers of DP&L.

***Q25. DOES NYMEX COAL NORMALLY SELL FOR A PREMIUM OVER HIGH SULFUR ILLINOIS BASIN COAL?***

***A25.*** Yes, NYMEX coal typically trades at a premium over high sulfur Illinois Basin coal. For example, Exhibit GS-2, which is a copy of a recent daily price report from SNL Financial, shows a variety of Central Appalachia, Northern Appalachia and Illinois Basin coals available in the market on May 21, 2012. As this exhibit illustrates, lower sulfur coals typically trade for a higher price than higher sulfur coals with similar heating values. Rail delivery versus barge delivery can also have an impact on the price of the coal. For example, on Monday, May 21, 2012, the SNL report shows that NYMEX look-alike coal (listed in the Central Appalachia section) is selling for $59.80/ton for delivery in 3rdquarter 2012. High sulfur Illinois Basin coal (with a heating value of 11,800 Btu/lb.) is selling for $48.50/ton for delivery in the 3rd quarter 2012. This is a difference of $11.30/ton between the NYMEX coal and the high sulfur Illinois Basin coal. Since January 2007, except for a short five-month period from late November 2008 through April 2009, NYMEX coal has consistently traded at a higher price than the price for high sulfur Illinois Basin coal, as illustrated on Exhibit GS-3.

However, in the two and a half years since DP&L’s use of coal optimizations was approved, effective January 1, 2010 in the Stipulation and Recommendation in Case No. 08-1094-EL-SS0, NYMEX coal has always traded at a higher cost than high sulfur Illinois Basin coal.

***Q26. WHAT DO YOU RECOMMEND AS ALTERNATIVES TO THE OPTIMIZATION CALCULATION USED BY THE COMPANY?***

***A26.*** If Illinois Basin coal, or any other high sulfur coal that could be burned by DP&L, is trading below the cost of NYMEX coal at the time coal needs to be purchased (Time A), then it would be prudent to purchase the lower cost coal so that customers will be charged less, consistent with the ESP Stipulation commitment to implement a rider based on “least cost fuel”[[29]](#footnote-29) being allocated to retail customers.

If the Company has the ability to burn high sulfur coal, but purchases NYMEX coal for resale, the optimization benefit as currently calculated should be altered so that it is based on the price of Illinois Basin coal at the time of the original NYMEX coal purchase and the price of the replacement Illinois Basin coal. The fact that the Company purchases the NYMEX coal and eventually sells it for a profit and then buys and burns the high sulfur Illinois Basin coal at a lower cost than the sales price of the NYMEX coal does not guarantee that the optimization charge applied to the FUEL Rider was prudent or a least cost option for customers.

Another approach, and one that is in accord with the language found in the Stipulation and Recommendation in Case No. 08-1094-EL-SSO, would be to simply credit twenty-five percent of any coal sales gains to the FUEL Rider in order to reduce the cost to customers.

***Q27. WHAT WAS THE PRICE OF THE ILLINOIS BASIN COAL AT TIME A AND TIME B?***

***A27.*** Exhibit GS-3 shows the difference in cost between NYMEX coal and high sulfur Illinois Basin coal since the Company has been calculating optimization benefits (January 1, 2010 to present). For example, at time A, when NYMEX coal was trading at $61.75/ton, Illinois Basin coal was trading for $47.00/ ton, a $14.75/ton difference. At time B, when NYMEX coal was trading at $63.75/ton, the Illinois Basin coal was trading at $48.00/ton, a difference of $15.75/ton.

***Q28. HOW DO THESE PRICES COMPARE WITH THE CHARGE TO THE FUEL RIDER THAT CUSTOMERS PAY?***

***A28.*** As shown in the third calculation of Exhibit GS-1, the net charge to the Fuel Rider for NYMEX A is $57.56/ton and the net charge to the Fuel Rider for NYMEX B is $59.56/ton. In each case, the resultant charge to the fuel rider using DP&L’s optimization benefit calculation is greater than what it would have been had the Company chosen to buy Illinois Basin coal at time A and time B. For NYMEX A there is an additional $3.56/ton charge to the Fuel Rider ($57.56/ton - $54.00/ton) and for NYMEX B there is an additional $4.56/ton charge to the Fuel Rider ($59.56/ton - $55.00/ton).

***Q29. WHAT EFFECT DOES DP&L’S OPTIMIZATION PROCESS HAVE ON THE RATES THAT CUSTOMERS PAY IN THIS EXAMPLE?***

***A29***. It increases the overall cost of electricity to customers, because DP&L’s 75% share of the calculated optimization benefit is added to the Fuel Rider to be collected from customers. Unless the cost differential between the replacement coal purchased at time C is significantly below the price of the Illinois Basin coal that could have been purchased at times A and B, the optimization calculation will not result in a least cost FUEL Rider being allocated to retail customers.

***Q30. IS THE DIFFERENCE BETWEEN THE PRICE OF ILLINOIS BASIN COAL (AT TIME A AND TIME B) AND THE COST OF REPLACEMENT COAL (AT TIME C) EVER SIGNIFICANT ENOUGH TO PROVIDE A LEAST COST ALTERNATIVE FOR CUSTOMERS?***

***A30.*** No. I ran a number of price scenarios for the cost of replacement coal (calculation #2 of Exhibit GS-4) to determine what price was necessary in order to match the total delivered price of purchasing Illinois Basin Coal at time A and at time B, rather than purchasing NYMEX coal. Based on my calculations, and using the same numbers from the coal optimization example shown in Exhibit GS-1, Exhibit GS-4 illustrates how the replacement coal for the NYMEX A coal would have to sell for less than $33.00/ton and the replacement coal for the NYMEX B coal would have to sell for less than $29.00/ton, in order to begin to create a savings for customers.

***Q31. HAS HIGH SULFUR ILLINOIS BASIN COAL TRADED AT, OR BELOW, $33.00/TON SINCE THE FUEL OPTIMIZATION PROGRAM HAS BEEN IN EFFECT?***

***A31.*** No. As shown on Exhibit GS-3, for more than two and half years since January 1, 2010 (the date when DP&L began use of coal optimizations per the Stipulation and Recommendation in Case No. 08-1094-EL-SS0), high sulfur Illinois Basin coal has not traded below $40.00/ton. Therefore, based on purchasing NYMEX coal at time A and time B, there was never a point in time where the two NYMEX coal purchases could have been sold and a replacement Illinois Basin coal could have been purchased so that it would have provided a savings to customers.

***Q32. HOW HAS THE ADDITION OF THE FUEL OPTIMIZATION BENEFIT CALCULATION IMPACTED THE FINAL FUEL “EXPENSES” COLLECTED FROM CUSTOMERS THROUGH THE FUEL RIDER CURRENTLY IN PLACE?***

***A32.*** In the example shown in Exhibit GS-1, instead of a $57.56/ton charge to the Fuel Rider for coal originally purchased at time A, the fuel rider should have been charged $54.00/ton ($47.00/ton for the actual coal price of Illinois Basin coal at time A plus the $7.00/ton differential in transport and operations and maintenance expense for burning the Illinois Basin coal). Instead of a $59.56/ton charge to the Fuel Rider for coal originally purchased at time B, the fuel rider should have been charged $55.00/ton ($48.00 for the actual coal price of Illinois Basin coal at time B plus the $7.00/ton additional cost in transport and operations and maintenance expense for burning the Illinois Basin coal).

***Q33.*** ***IS THERE ANOTHER PROBLEM WITH THE FUEL OPTIMIZATION BENEFIT CALCULATION?***

***A33.*** Yes. The most significant problem with the optimization calculation is that it does not accurately credit optimization benefits to the FUEL Riders contemplated in the Stipulation and Recommendation for the approval of the Electric Security Plan in Case No. 08-1094-EL-SSO. This issue goes back to the genesis of the approval of the fuel rider and optimization process. The Company first received approval to implement a bypassable fuel recovery rider to recover fuel and purchased power costs, based on least cost fuel and purchased power being allocated to retail customers. The stipulation stated that“[t]o calculate the fuel rider, jurisdictional emission allowance proceeds and twenty-five percent of jurisdictional coal sales gains will be netted against the fuel and purchased power costs.”[[30]](#footnote-30) Then in the application to establish a fuel rider, Case No.09-1012-EL-UNC, the Company again stated “[t]he net proceeds of the jurisdictional share of optimization transactions are shared with 25% of the net proceeds being credited to retail customers based on the Stipulation provisions.”[[31]](#footnote-31)

However, as was previously described, DP&L is using an accounting process illustrated by the coal optimization example shown on Exhibit GS-1. The Company includes as a fuel optimization transaction not only the initial coal sale gains, but also the subsequent replacement coal price. If the Company was following the simple process for coal optimization as outlined in the ESP Stipulation, the optimization calculation should look like the example shown on Exhibit GS-5, which utilizes the same prices for coal as in Exhibit GS-1 and Exhibit GS-4. In Exhibit GS-5, the optimization transaction is simply twenty-five percent of the proceeds from the jurisdictional coal sale gains, which are netted against the fuel and purchased power costs, just as described in the ESP Stipulation. Based on this accounting process, the charge to the fuel rider would have been $51.56/ton for NYMEX A and $52.06/ton for NYMEX B, a significant savings for retail customers from the $57.56/ton for NYMEX A and $59.56/ton for NYMEX B as shown in Exhibit GS-1.

If DP&L would have calculated the optimization benefits the way the concept was described in the ESP Stipulation from Case No. 08-1094-EL-SSO, as shown on Exhibit GS-5, then retail customers could have experienced a net decrease to the fuel and purchased power costs. However, even with this accounting process, there are times when it might still have been cheaper to simply buy the lower cost Illinois Basin coal with the initial transaction, assuming the Company was capable of burning the higher sulfur coal.

***Q34. DOES THE COMPANY INDICATE THAT IT IS CREDITING 25% OF THE COAL SALES GAINS AGAINST THE FUEL AND PURCHASED POWER COSTS FOR 2011?***

***A34.*** In response to OCC discovery, which asked the same question, DP&L stated “As discussed in LA-2010-44 and agreed to in the Settlement, DP&L credits 100% of the accounting gains and charges 75% of the optimization value to the Fuel Rider. This has the end-result of crediting 25% of the optimization value to the customers.”[[32]](#footnote-32)

***Q35. DO YOU AGREE WITH THE COMPANY’S ASSERTION THAT CREDITING 100% OF THE COAL GAINS TO THE FUEL RIDER AND THEN CHARGING 75% OF THE OPTIMIZATION VALUE TO THE FUEL RIDER HAS THE SAME END-RESULT OF CREDITING 25% OF THE GOAL SALES GAINS AGAINST THE FUEL RIDER?***

***A35.*** No. As shown in the comparison of the two coal optimization calculations, Exhibit GS-1 and Exhibit GS-5, the impact from crediting 100% of the coal gains to the FUEL Rider and then charging 75% of the optimization value to the FUEL Rider can add significantly more costs to the FUEL Rider than simply crediting 25% of the coal sales gains to the FUEL Rider. Based on the examples of a coal optimization shown in Exhibit GS-1 and Exhibit GS-5, DP&L’s current accounting process for optimizations (Exhibit GS-1) charges the fuel rider an additional $6/ton for NYMEX A coal and $7.50/ton for NYMEX B coal, than the FUEL Rider would have been charged by just crediting 25% of the coal sales gains to the FUEL Rider.

# V. AUDIT FINDINGS AND RECOMMENDATIONS

***Q36. WHAT WERE THE AUDITOR'S FINDINGS IN REGARD TO ITS 2010 AUDIT OF THE COMPANY’S FUEL OPTIMIZATION ACTIVITIES?***

***A36.*** In the 2010 Audit Report, EVA expressed a number of concerns related to the Company’s optimization activities, including:

1. The Company did not verify that all the optimization transactions had reduced cost for retail customers;

2. The Company needed to implement policies around optimization transactions, including requiring that any purchases of NYMEX futures contracts include a corresponding analysis of acquiring high sulfur coal, or no coal, as alternatives; and

3. The Company needed to implement a hedging strategy for the type and quality of coal it forecast to burn and should not enter into NYMEX hedges that exceed its expected low sulfur coal consumption.[[33]](#footnote-33)

***Q37. WERE ANY OF THE CONCERNS FROM THE 2010 AUDIT STILL PRESENT IN THE 2011 FUEL AUDIT?***

***A37.*** Yes. A number of concerns detailed in the Stipulation and Recommendation of the Company’s 2010 Audit of the fuel rider (to which the OCC was a party) were addressed by DP&L. But several of the Auditor’s concerns related to DP&L’s optimization transactions were not satisfied. One of the remaining concerns was DP&L’s failure to demonstrate the benefits of the optimization transactions to jurisdictional customers.[[34]](#footnote-34)

***Q38. DID THE 2011 AUDIT PRESENT ANY NEW CONCERNS RELATED TO THE 2010 AUDIT REVIEW?***

***A38.*** Yes. During the course of the 2011 audit, DP&L reported to the auditor 12 optimizations for 2011 totaling $7.3 million charged to the FUEL Rider.[[35]](#footnote-35) However, three of the optimizations reported by the Company in 2011 occurred in 2010, but were not disclosed until 2011.[[36]](#footnote-36) The three 2010 optimizations not disclosed until 2011 account for the overwhelming majority of the $7.3 million of 2011 FUEL Rider charges from optimization transactions. The Auditor was especially concerned “\* \* \*about the failure to disclose as considerable effort was made during the prior audit period to explain to DP&L that the scope of the audit included all decisions made in 2010, not simply purchases.”[[37]](#footnote-37) In addition, the Auditor went on to say “\* \* \* EVA believes that any components of the FUEL Rider Stipulation may not be relevant in this review given DP&L’s lack of full disclosure on 2010 optimizations in 2011.”[[38]](#footnote-38) The PUCO should determine what the consequences should be for DP&L’s lack of full disclosure.

***Q39. DID THE AUDITOR UNDERSTAND WHY THE 2010 OPTIMIZATIONS WERE NOT REPORTED BY DP&L DURING THE 2010 AUDIT?***

***A39.*** No. The Auditor indicated there was some initial confusion regarding the scope of the 2010 audit, but Staff and EVA explained to DP&L that all 2010 transactions were to be reviewed whether or not fuel was delivered in 2010[[39]](#footnote-39) and “\*\*\*considerable effort was made during the prior audit period to explain to DP&L that the scope of the audit included all decisions made in 2010, not simply purchases.”[[40]](#footnote-40) After the scope issue was resolved with the Company, EVA was “led to believe” that all relevant and requested information had been provided by the Company.[[41]](#footnote-41)

***Q40. WHAT WERE THE AUDITOR’S RECOMMENDATIONS REGARDING FUEL OPTIMIZATIONS FROM THE 2011 FUEL AUDIT?***

***A40.*** The Auditor had several recommendations related to optimizations in the 2011 fuel audit. These recommendations were:

1. The Fuel Rider should be adjusted to delete the optimization values associated with Optimization 2011-A;
2. The Fuel Rider should be adjusted to delete the optimization values associated with Optimization 2011-E;
3. DP&L should revise its optimization calculations for the remaining optimizations using a more rigorous and documented analytical approach. The revised optimizations should be available for review as part of the next audit and remain subject to adjustment at that time; and
4. DP&L should expand its optimization documentation to include the gains/losses on the underlying hedges.[[42]](#footnote-42)

***Q41. DO YOU AGREE WITH THE AUDITOR’S RECOMMENDATIONS FROM THE 2011 FUEL AUDIT REGARDING FUEL OPTIMIZATIONS?***

***A41.*** Yes, I agree with the Auditor’s recommendations. However, the Auditor’s recommendations fail to request that the charge to the FUEL Rider should be reduced to delete the optimization values associated with the remaining ten optimizations from the 2011 Audit. And the Auditor fails to request that the charge to the FUEL Rider should be reduced for 25% of the jurisdictional coal sales gains in 2011 to comply with the ESP Stipulation.

***Q42.*** ***PLEASE SUMMARIZE YOUR FINDINGS AND RECOMMENDATIONS REGARDING THE FUEL OPTIMIZATION PROVISIONS CURRENTLY IN DP&L’S FUEL RIDER.***

***A42.*** The fuel optimization benefit calculation developed by the Company is flawed. Instead of providing customers a savings, the fuel optimization calculation developed by the Company can actually increase the Fuel Rider (as illustrated in Exhibit GS-1), costing customers money. Therefore, I recommend that the PUCO adopt the following:

1. The calculation of the optimization benefit to be netted against the FUEL Rider, as illustrated in Exhibit GS-5, should only include jurisdictional emission allowance proceeds and twenty-five percent of jurisdictional coal sales gains for all optimization transactions that are part of the 2011 Audit and any subsequent audit periods covered by the 2009 ESP (i.e. 2012).
2. If the optimization calculation as illustrated in Exhibit GS-1 is to remain in effect, all fuel transactions involving the purchase and sale of NYMEX coal should be excluded from fuel optimization benefits calculations, whenever lower quality and lower cost coal (such as an Illinois Basin coal) is purchased as a replacement for the NYMEX coal.
3. Any optimization benefit claimed by DP&L for the 2011 Audit and any subsequent audit periods covered by the ESP must include clear, written documentation of how the transaction lowered cost to its customers.

# VI. CONCLUSION

***Q43*. *BASED ON YOUR REVIEW OF THE COMPANY’S FUEL OPTIMIZATION PROGRAM, WHAT IS YOUR RECOMMENDATION?***

***A43*.** I recommend the Commission reduce the charge to the FUEL Rider by $7.3 million for the 2011 optimizations, including optimization 2011-A and 2011-E as recommended by the Auditor. I also recommend that twenty-five percent of the proceeds from 2011 coal sales gains, including the coal sales gains from the 12 optimizations identified for 2011 be credited to the FUEL Rider. This approach will provide an appropriate outcome for DP&L’s customer that is consistent with the ESP Stipulation.

In addition I recommend the Commission disallow any resulting future impact to the Fuel Rider from DP&L’s share of any fuel optimization benefits that DP&L does not affirmatively prove to be a net benefit to customers, consistent with least cost fuel being allocated to retail customers.

***Q44. DOES THIS CONCLUDE YOUR TESTIMONY AT THIS TIME?***

***A44.*** Yes. However, I reserve the right to address new issues and incorporate new information that may subsequently become available through discovery or otherwise.

**CERTIFICATE OF SERVICE**

I hereby certify that a copy of the foregoing *Direct Testimony of Gregory Slone* was served via electronic transmission to the persons listed below, this 4th day of October, 2012.

*/s/ Kyle L. Kern\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_*

Kyle L. Kern

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1. See Company’s response to OCC Discovery Set 1 in Case No. 11-5730-EL-FAC, at INT-1(D). [↑](#footnote-ref-1)
2. See R.C. 4928.143(B)(2)(a). [↑](#footnote-ref-2)
3. *In the Matter of the Dayton Power and Light Company For Approval of Its Electric Security Plan*, Case No. 08-1094-EL-SSO, Stipulation and Recommendation (February 24, 2009) at 3. [↑](#footnote-ref-3)
4. Id. [↑](#footnote-ref-4)
5. *Application of the Dayton Power and Light Company to Establish a Fuel Rider*, Case No. 09-1012-EL-UNC [↑](#footnote-ref-5)
6. *In the Matter of the Application of The Dayton Power and Light Company to Establish a Fuel Rider*, Case No. 09-1012-EL-FAC, Stipulation and Recommendation (October 5, 2011) at 5,7 and 9. [↑](#footnote-ref-6)
7. *Report of the Management/Performance and Financial Audit of the Fuel and Purchased Power Rider of the Dayton Power and Light Company*, Case No. 11-5730-EL-FAC, at 1-4, number 3. [↑](#footnote-ref-7)
8. Id. at 1-9 and 1-10; see also, Case No. 09-1012-EL-FAC, Stipulation and Recommendation (October 5, 2011) at 8, ¶4 (a). [↑](#footnote-ref-8)
9. *Report of the Management/Performance and Financial Audit of the Fuel and Purchased Power Rider of the Dayton Power and Light Company*, Case No. 11-5730-EL-FAC, at 1-10 and 1-11. [↑](#footnote-ref-9)
10. *In the Matter of the Dayton Power and Light Company For Approval of Its Electric Security Plan*, Case No. 08-1094-EL-SSO, Stipulation and Recommendation (February 24, 2009) at 3 and 4. [↑](#footnote-ref-10)
11. Id. [↑](#footnote-ref-11)
12. Id. [↑](#footnote-ref-12)
13. *Report of the Management/Performance and Financial Audit of the Fuel and Purchased Power Rider of the Dayton Power and Light Company*, Case No. 09-1012-EL-FAC, at 1-6, Section 19, and Case No.11-5730-EL-FAC, at 1-4, Section 3. [↑](#footnote-ref-13)
14. See R.C. 4928.143(B)(2)(a). [↑](#footnote-ref-14)
15. Id. [↑](#footnote-ref-15)
16. *In the Matter of the Application of The Dayton Power and Light Company for Approval of Its Electric Security Plan,* Case No. 08-1094-EL-SSO et al., Stipulation and Recommendation at 3-4, ¶2 (Feb. 24, 2009); *In the Matter of the Application of The Dayton Power and Light Company to Establish a Fuel Rider*, Case No. 09-1012-EL-FAC, Stipulation and Recommendation at 8, ¶4(a). (October 5, 2011). [↑](#footnote-ref-16)
17. *Report of the Management/Performance and Financial Audit of the Fuel and Purchased Power Rider of the Dayton Power and Light Company*, Case No. 11-5730-EL-FAC, at 4-1. [↑](#footnote-ref-17)
18. *Application of the Dayton Power and Light Company to Establish a Fuel Rider*, Case No. 09-1012-EL-UNC, at 7. [↑](#footnote-ref-18)
19. *Report of the Management/Performance and Financial Audit of the Fuel and Purchased Power Rider of the Dayton Power and Light Company*, Case No. 11-5730-EL-FAC, at 4-1 and *Application of the Dayton Power and Light Company to Establish a Fuel Rider*, Case No. 09-1012-EL-UNC, at 7. [↑](#footnote-ref-19)
20. See R.C. 4928.143(B)(2)(a). [↑](#footnote-ref-20)
21. *Report of the Management/Performance and Financial Audit of the Fuel and Purchased Power Rider of the Dayton Power and Light Company*, Case No. 11-5730-EL-FAC, at 1-4, number 3. [↑](#footnote-ref-21)
22. *In the Matter of the Application of The Dayton Power and Light Company for Approval of Its Electric Security Plan*, Case No. 08-1094-EL-SSO, Stipulation and Recommendation (February 24, 2009) at 3. [↑](#footnote-ref-22)
23. *Application of the Dayton Power and Light Company to Establish a Fuel Rider*, Case No. 09-1012-EL-UNC at 7. [↑](#footnote-ref-23)
24. *Report of the Management/Performance and Financial Audit of the Fuel and Purchased Power Rider of the Dayton Power and Light Company*, Case No. 11-5730-EL-FAC, at 1-4, section 3. (Emphasis added). [↑](#footnote-ref-24)
25. *Report of the Management/Performance and Financial Audit of the Fuel and Purchased Power Rider of the Dayton Power and Light Company*, Case No. 09-1012-EL-FAC, at page 4-2 and 4-3. [↑](#footnote-ref-25)
26. Id. at page 4-3. [↑](#footnote-ref-26)
27. **SOURCE: SNL Financial LC. CONTAINS COPYRIGHTED MATERIAL DISTRIBUTED UNDER LICENSE FROM SNL**. *Weak Coal Market Leaving Holes In Open-hopper Barge Capacity for 2012*, June 15, 2012 and *NIPSCO Staying Out Of Spot Coal Market As Coal inventories Swell*, May 11, 2012. [↑](#footnote-ref-27)
28. *Report of the Management/Performance and Financial Audit of the Fuel and Purchased Power Rider of the Dayton Power and Light Company*, Case No. 11-5730-EL-FAC, at 2-4 and 2-5. [↑](#footnote-ref-28)
29. *In the Matter of the Application of The Dayton Power and Light Company for Approval of Its Electric Security Plan,* Case No. 08-1094-EL-SSO et al., Stipulation and Recommendation at 3, ¶2 (Feb. 24, 2009). [↑](#footnote-ref-29)
30. *In the Matter of the Application of The Dayton Power and Light Company for Approval of Its Electric Security Plan*, Case No. 08-1094-EL-SSO, Stipulation and Recommendation (February 24, 2009) at 3and 4. [↑](#footnote-ref-30)
31. *Application of the Dayton Power and Light Company to Establish a Fuel Rider*, Case No. 09-1012-EL-UNC at 4. [↑](#footnote-ref-31)
32. See Company’s response to OCC Discovery Set 1 in Case No. 11-5730-EL-FAC, at INT-1(B). [↑](#footnote-ref-32)
33. *Report of the Management/Performance and Financial Audit of the Fuel and Purchased Power Rider of the Dayton Power and Light Company*, Case No. 09-1012-EL-FAC, at 1-6, number 19, 20 and 21. [↑](#footnote-ref-33)
34. *Report of the Management/Performance and Financial Audit of the Fuel and Purchased Power Rider of the Dayton Power and Light Company*, Case No. 11-5730-EL-FAC, at 1-4, section 3. [↑](#footnote-ref-34)
35. Id at 4-6. [↑](#footnote-ref-35)
36. Id. [↑](#footnote-ref-36)
37. Id. [↑](#footnote-ref-37)
38. Id. [↑](#footnote-ref-38)
39. Id. at 1-9. [↑](#footnote-ref-39)
40. Id. at 4-6. [↑](#footnote-ref-40)
41. Id. at 1-9. [↑](#footnote-ref-41)
42. Id. at 1-10 and 1-11. [↑](#footnote-ref-42)