

FILE

BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

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|--|---|------------------------|
| In the Matter of the Application of |) | |
| Columbus Southern Power Company for |) | |
| Approval of its Electric Security Plan; an |) | Case No. 08-917-El-SSO |
| Amendment to its Corporate Separation |) | |
| Plan; and the Sale or Transfer of Certain |) | |
| Generating Assets |) | |

and

| | | |
|---------------------------------------|---|------------------------|
| In the Matter of the Application of |) | |
| Ohio Power Company for Approval of |) | |
| its Electric Security Plan; and an |) | Case No. 08-918-EL-SSO |
| Amendment to its Corporate Separation |) | |
| Plan |) | |

REBUTTAL TESTIMONY
OF
PHILIP J. NELSON
ON BEHALF OF
COLUMBUS SOUTHERN POWER COMPANY
AND
OHIO POWER COMPANY

PUCO

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THE PUBLIC UTILITIES COMMISSION OF OHIO
REBUTTAL TESTIMONY OF
PHILIP J. NELSON
ON BEHALF OF
COLUMBUS SOUTHERN POWER COMPANY
AND
OHIO POWER COMPANY
PUCO CASE NO. – 08-917-EL-SSO
PUCO CASE NO. – 08-918-EL-SSO

Q. Please state your name.

A. My name is Philip J. Nelson

Q. What is the purpose of your rebuttal testimony?

A. In my rebuttal testimony I address the following positions asserted by the Staff and various intervenors: 1) The use of 2007 or 2008 fuel costs to identify the fuel rate component in the current standard service offer (SSO); 2) Denial of carrying charges on 2001-2008 incremental environmental investment; and 3) Challenges to the use of a weighted average cost of capital (WACC) and other carrying charge issues.

Fuel Rate Baseline

Q. OCC's witness Smith wants to use 2008 fuel costs as the basis for establishing the fuel rate component of the Companies' current SSO rates. Does this make sense?

A. No. There are several reasons why this does not make sense. First of all one must understand that the purpose of identifying the FAC in the current SSO is to establish the non-FAC or Base SSO in current rates. This is in essence an unbundling process that is necessary to implement an active fuel mechanism where none exists currently. This is done by subtracting from the current Total SSO, the current FAC SSO component, to arrive at the current non-FAC component. Using fuel costs, rather than fuel rates, to determine the FAC baseline rate results in the non-FAC portion of the generation rates floating with whatever assumption is made for FAC costs.

1 The Companies started with the FAC rate component in the 2001 SSO rate. As I
2 explained in my direct testimony, subsequent increases to the FAC portion of the total
3 SSO are identifiable through the RSP and PAR cases that occurred after the original
4 unbundling case. This method resulted in a 22.5% increase in the original unbundled
5 FAC rate for OPCO and a 17.8% increase for CSP. By contrast, OCC witness Smith's
6 use of FAC costs, which vary monthly and do not reflect the FAC embedded in rates, is
7 subjective and arbitrary.

8 **Q. Are there other problems with using 2008 fuel costs to determine the Non-FAC**
9 **SSO?**

10 A. Yes. 2008 is shaping up to be one of the most volatile years in the Companies' fuel costs
11 for many decades. To determine the non-FAC SSO by subtracting from the total SSO
12 fuel costs within such a volatile period would be inappropriate. Deciding what fuel costs
13 to use from such a volatile and unrepresentative period would likely require resolution of
14 protracted disputes about out-of-period adjustments – all stemming from using a
15 methodology that does not make sense in the first place.

16 **Q. What is Staff witness Cahaan's recommendation for determining the FAC**
17 **component of the Companies' current SSO?**

18 A. Staff recommends using 2007 fuel cost with a 3% escalation for CSP and a 7% escalation
19 for OPCO. Mr. Cahaan describes his method as a top-down approach and the
20 Companies' method of determining the FAC rate component of the current SSO as an
21 accounting or bottom-up approach. Mr. Cahaan's justification for using the top-down
22 method is that the Companies' 2007 rates were sufficient to cover 2007 fuel costs.

1 Staff's method is subject to the same criticisms as mentioned above, but since
2 escalated 2007 costs, as proposed by Mr. Cahaan, produce a known result very close to
3 the Companies' method, it would not significantly change the results of the Companies'
4 overall plan. The fact that Staff's 2007 approach and OCC's approach will produce
5 substantially different results indicates the deficiency of picking a particular year's costs
6 to determine a proxy for rates.

7 **Q. Why do you disagree with the top-down approach and the concept that since the**
8 **Companies earned good returns in 2007 and might earn good returns in 2008 that**
9 **OCC's and Staff's approaches are justified?**

10 **A.** I disagree because it is an improper cost-of-service approach to setting rates. It
11 effectively applies an earnings test retroactively to the RSP period, when no such
12 earnings test should be applied. It also applies an earnings test prospectively, in effect,
13 to the Companies' ESP at the outset of that plan when, I understand, no such earnings test
14 is permitted for a three-year ESP plan. If the Companies' total plan, including the
15 method of identifying the FAC component of the current SSO, results in substantially
16 excessive earnings then customers are protected under SB 221. Using 2008 FAC costs is
17 inconsistent with the rest of the ESP which was premised on the Companies' FAC
18 proposal and might result in unacceptable returns if 2008 FAC costs were used. Mr.
19 Baker addresses this concern in his rebuttal testimony.

20 **Q. Setting aside the criticisms of using fuel "costs" as a proxy for what is in the**
21 **Companies' current SSO rates, do the historical FAC costs support the**
22 **reasonableness of using the Companies' approach to identifying the FAC rate**
23 **component of their current SSO rate?**

A. Yes. Based on data provided to the Staff in interrogatory 12-2, the historical cost data for OPCO is below the FAC rate identified by the Companies for every year from 2001 through 2007. For CSP, only one year, 2006, exceeded the FAC rate identified in current rates by the Companies. Below is a summary of historical FAC costs compared to the Companies' calculated current FAC rates and the Staff's recommended current FAC costs. I believe the following confirms that the Companies have not overstated the non-FAC rate component of the current SSO, by understating the FAC rate component.

**2001-2007 FAC Costs Compared to
The Companies' and Staff's FAC Component of the Current SSO**

| <u>YEAR</u> | <u>Cents/kwh Columbus Southern Power</u> | | <u>Cents/kwh Ohio Power</u> | |
|------------------|--|-------|---------------------------------|-------|
| 2001 | 2.109 | | 1.726 | |
| 2002 | 2.133 | | 1.347 | |
| 2003 | 2.212 | | 1.298 | |
| 2004 | 2.281 | | 1.381 | |
| 2005 | 2.527 | | 1.645 | |
| 2006 | 2.707 | | 1.732 | |
| 2007 | 2.549 | | 1.642 | |
| Company FAC Rate | Exhibit PJN-1 (REV) | 2.562 | Exhibit PJN-4 (REV) | 1.780 |
| Staff Proposal | Hess Workpaper | 2.625 | Hess Workpaper | 1.757 |

2001-2008 Environmental Carrying Costs

Q. OCC witness Smith takes the position that the Commission should disallow the Carrying Charges on incremental 2001-2008 environmental capital investments made by the Companies. Do you agree with her recommendation?

A. No. Ms. Smith offers very little rationale or support for her position. She cites two bases for the disallowance: 1) either the Companies do not have enough earnings to pay for these investments or that 2) the Companies will not make these investments without additional revenues and they are investments which are in the public interest. She also

1 states that "Moreover stockholders will reap the benefits over the lives of these
2 investments."

3 Ms. Smith's first two criticisms are difficult to follow. In any event, as far as I am
4 aware, the criteria on which they appear to be based are not set out in S.B. 221; nor do
5 they relate to the Companies' request for carrying charges on a portion of their
6 incremental 2001-2008 environmental investment. The vast majority of the expenditures
7 shown in Exhibit PJN-9 have already been made.

8 Concerning witness Smith's statement that stockholders will reap the benefits, it
9 is clear that, if a company is not paid for such investments, shareholders will not reap any
10 benefits associated with that investment. By implying that these investments do not
11 benefit customers, she appears to misunderstand the nature of these investments. These
12 environmental investments are necessary to keep the Companies' low-cost coal-fired
13 generating units running. The customers will benefit because the operating costs of these
14 units remain well below the cost of securing the power on the market. The Companies
15 are passing the lower-cost power through the FAC. Furthermore, the Companies'
16 customers and the State of Ohio benefit when the Companies purchase locally produced
17 high-sulfur coal for use in its generating units, which is facilitated through these
18 environmental investments.

19 **Carrying Cost Issues**

20 **Q. What carrying cost issues have been raised by intervenors in this proceeding?**

21 A. There have been several challenges on the capital carrying costs used by the Companies
22 in this proceeding to calculate their capital carrying costs on environmental investments
23 as well as those associated with the FAC deferrals.

1 One such criticism is that the cost of debt and not the full weighted cost of capital
2 (WACC) should be used in carrying cost calculations. There is no merit to these
3 suggestions. The Companies have invested over \$3 billion in environmental investment
4 since the start of the market development period. This could not possibly have been
5 financed with only debt. This environmental plant investment is no different than other
6 capital investments that have historically garnered returns based on a WACC, not just on
7 debt costs. In all cases that I have been involved in since SB3, the WACC has been used
8 for calculating carrying costs on environmental investment. The capital structure used by
9 the Companies in this case and used by the Commission in the RSP cases excluded short-
10 term debt for both Companies and for OPCO excluded the Gavin Lease (JMG Funding)
11 from the capital structure. While GAAP accounting requires the lease to be reflected on
12 the balance sheet of OPCO, the ratemaking treatment reflects it as an operating lease
13 rather than a component of rate base. The 50/50 debt to equity capital structure used on
14 PJN-10 was based on a review of the quarter ended March 31, 2008 and the expectation
15 that the Companies will maintain a similar capital structure during the ESP.

16 Finally, it was suggested by OEG witness Gorman that the FAC phase-in
17 deferrals could be financed with short-term debt. This is not realistic. First, a period of 8
18 to 10 years, or for that matter even 3 years, is not short-term. At best, it is an
19 intermediate term and to rely on short-term financing resources for such large deferrals
20 would create liquidity issues for the Companies, *i.e.*, too much short-term debt might
21 prevent any additional short-term borrowing necessary to finance the business' day-to-
22 day business needs. The Companies will be financing the phase-in deferrals with both
23 long-term debt and equity, in order not to experience an adverse change in their

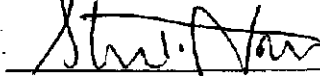
1 capitalization. Therefore, a carrying charge based upon the weighted average cost of
2 capital is appropriate and necessary to make the Companies whole. Also, the suggestion
3 that the Companies could obtain bank lines of credit to fund the phase-in deferrals on a
4 short-term basis during the current credit crisis is similarly unwise and unrealistic. New
5 credit is not readily available and it would be difficult to obtain a separate credit facility
6 to finance the large proposed phase-in deferrals.

7 **Q. Does this conclude your rebuttal testimony?**

8 **A. Yes.**

CERTIFICATE OF SERVICE

I hereby certify that a copy of Columbus Southern Power Company's and Ohio Power Company's Rebuttal Testimony of Philip J. Nelson was served by electronic mail upon counsel identified below this 8th day of December, 2008.


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