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Post hearing brief of Industrial Energy Users-Ohio.

BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application Of The Cincinnati Gas & Electric Company to Modify its Quarterly Fuel and Purchased Power Component of its Market-Based Standard Service Offer	))))))	Case No. 05-806-EL-UNC

POST-HEARING BRIEF OF INDUSTRIAL ENERGY USERS-OHIO

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I. INTRODUCTION

Despite efforts by many stakeholders to reach the goals envisioned by the enactment of Ohio's electric restructuring legislation, Amended Substitute Senate Bill 3 ("SB 3') a competitive market has not sufficiently evolved within the market development period ("MDP"), the time period contemplated for such a market to develop. SB 3 envisioned a robust wholesale generation market and fully functional regional transmission organizations ("RTOs") arriving during the MDP.

Furthermore, the efforts of the Federal Energy Regulatory Commission ("FERC") to standardize the design of electric markets to more effectively address reliability and price objectives have been greeted with political outbursts that seem to suggest that government has the power to vacate or suspend the law of physics. These conditions sharply conflict with the vision that runs through Ohio's electric restructuring legislation, which was designed and enacted on the assumption that the wholesale market would be sufficiently robust and mature to provide a reliable supply and a transparent and liquid source of reasonable prices after the MDP.

Recognizing the state of the market, the Public Utilities Commission of Ohio ("Commission") issued an Entry on September 2, 2003 encouraging electric distribution utilities ("EDUs") to file plans that would stabilize rates for Ohio consumers and avoid rate shock that could result from subjecting customers to volatile and unreasonable rates on January 1, 2006 (after the end of the MDP). *In the Matter of the Continuation of the Rate Freeze and Extension of the Market Development Period for The Dayton Power & Light Company*, Case Nos. 02-2779-EL-ATA, *et al.*, Opinion and Order at 29 (September 2, 2003) (hereinafter "*DP&L Opinion and Order*"). The Commission observed that this action was necessary in light of the slower than expected pace of development of a competitive retail electric market in Ohio. *DP&L Opinion and Order* at 29. The Commission also specifically encouraged the EDUs to "consider and develop plans for 2005 and beyond, which balanced three objectives: rate certainty, financial stability for the electric distribution utilities and further competitive market development." *In the Matter of FirstEnergy Corp. on Behalf of Ohio Edison Company, The Cleveland Electric Illuminating Company, and The Toledo Edison Company for Approval of Tariff Adjustments,* Case No. 03-1461-EL-UNC, Entry at 4-5 (September 23, 2003).

This proceeding came about as a result of The Cincinnati Gas & Electric Company's ("CG&E") Rate Stabilization Plan ("RSP"), which was eventually approved by the Commission in its November 23, 2004 Entry on Rehearing. *In the Matter of the Application of The Cincinnati Gas & Electric Company to Modify Its Nonresidential Generation Rates to Provide for Market-Based Standard Service Offer Pricing and to Establish an Alternative Competitive-Bid Service Rate Option Subsequent to the Market Development Period,* Case No. 03-93-EL-ATA, Entry on Rehearing (November 23,

2004) (hereinafter "RSP Entry on Rehearing"). In its RSP Entry on Rehearing, the Commission authorized CG&E to establish a fuel and economy purchased power ("FPP") component to its market-based standard service offer ("MBSSO") subject to the Commission's annual review. RSP Entry on Rehearing at 10.

On June 1, 2005, CG&E filed an application in Case No. 05-725-EL-UNC, in which it proposed to establish the FPP rate for the period July 1, 2005 through September 30, 2005. *In The Matter of the Regulation of the Fuel and Economy Purchased Power Component of the Cincinnati Gas & Electric Company's Market-Based Standard Service Offer*, Case No. 05-806-EL-UNC, Entry at 2 (June 29, 2004). Subsequently, the Commission opened this docket (05-806-EL-UNC) for the purpose of initiating the annual review of the "FPP rates that have been charged by CG&E for the periods of January 1, 2005, through March 31, 2005; and April 1, 2005 through June 30, 2005." *Id.* at 2. Pursuant to other Commission Entries in these proceedings, the Commission Staff ("Staff") solicited bids, and the Commission selected, a third party auditor to conduct the audit of CG&E's FPP component for the period January 1, 2005 through June 30, 2005. *In The Matter of the Regulation of the Fuel and Economy Purchased Power Component of the Cincinnati Gas & Electric Company's Market-Based Standard Service Offer*, Case No. 05-806-EL-UNC, Entry at 1 (July 6, 2005).

The audit was conducted and a final report was filed with the Commission on October 7, 2005. The evidentiary hearing in this proceeding began on November 1, 2005 and concluded on November 2, 2005. Pursuant to the Attorney Examiners' Entry, Industrial Energy Users-Ohio ("IEU-Ohio") submits its Post-Hearing Brief in this matter.

IEU-Ohio directs its comments in this matter at the confusion that is created as a result of customers and utilities having to live in an environment where the regulators are struggling to deal with what was intended to be a fully competitive electric market with tools intended for use in a regulated regime. While IEU-Ohio has advocated for the implementation of RSPs to nurture a competitive market, the resulting confusion, as pointed out below, is proof that RSPs should not be used as a baseline or a benchmark for what consumers should expect as we move forward to assure that Ohioans pay just and reasonable rates. Furthermore, this confusion is proof that the Commission must take advantage of its authority to implement a plan that will ensure that Ohioans pay just and reasonable rates in the foreseeable future.

II. DISCUSSION

In its RSP Entry on Rehearing, the Commission clarified that "with regard to the FPP, the amounts to be recovered for fuel, economy purchased power, and [emission allowances] are those in excess of amounts authorized in CG&E's last electric fuel component proceeding." RSP Entry on Rehearing at 11. The implicit directive here is that the FPP component and the associated audits, hearings, and decisions be similar to the previous electric fuel component ("EFC") proceedings under the fully regulated regime. Indeed, the parties and the auditor have agreed that the function of the FPP and the audit be "EFC-like." Commission Ordered Exhibit 1 and 1A at 1-4.

However, application of the FPP under the current state of the market, which is somewhere between competition and regulation, creates a mismatch of expectations, requirements and duties when it comes to reviewing the actions of the utility for costs expected to be recovered from the consumer. The laws and rules regarding the

reporting and auditing of the EFC component became unnecessary with the enactment of SB 3 inasmuch as SB 3 eliminated the cost-based regulated justification of electric generation prices in lieu of market-based generation prices under the restructured regime.

Because we find ourselves somewhere in between full regulation and full competition, the Commission is left with having to decide what authority it has to review the actions of the utility when the utility requests to have the charges resulting from those actions passed through to ratepayers as though still operating in a regulated regime. The situation also leaves the Commission with having to decide what components of the charges should be included as recoverable within the riders approved in the RSP.

Throughout the evidentiary hearing there was much debate about these very issues, proving that while certain plans to assist in fostering a competitive electric market may be an adequate temporary fix, the plans cannot be held as long term solutions—or as benchmarks for long term solutions—inasmuch as components such as the FPP (based on traditional regulatory cost-based components) require a more rigorous analysis and evaluation process, which are not now codified in law or any Commission rule. The management and performance ("MP") auditor in this proceeding sufficiently pointed out this discrepancy in the final Audit Report:

> There are major differences between the EFC and the FPP which make an EFC-like review somewhat difficult. One major difference is that the EFC included all costs, while the FPP was intended to simply capture the difference between current and baseline costs. A second major difference relates to the fact that the FPP relates to only native customers and is for up to four years. As a result, CG&E views the related fuel and emission allowance commitments differently. A third major difference relates to the annual nature of

> the EFC, which provided continuity to the process. The last EFC audit of the CG&E was performed in 1999 and the company described therein bears little resemblance to the CG&E of today. More importantly, however, is the fact that during this transition period, CG&E operated as a deregulated entity. The re-entry into regulatory oversight with respect to the FPP creates a host of issues related to both the allocation of utility assets and CG&E's approach to fuel procurement.
>
> CG&E was required to make a number of decisions in computing the FPP. Because the order did not lay out the specifics, CG&E believed that it had the license to evaluate and select which approach to use. Not surprisingly, the range of alternative approaches was large and CG&E's elections have very significant ratepayer impacts. Compounding the auditing problems, CG&E has been continuously modifying its approach to many of these items.

Commission Ordered Exhibit 1 and 1A at 1-4 (footnotes omitted). A review of the former EFC auditing rules also helps to prove the point. For example, former Rule 4901:1-11-02(A), Ohio Administrative Code, states:

> Each electric utility shall endeavor to procure fuel, purchase power, and operate its generation, dispatch, transmission, and distribution systems at a minimum overall cost, taking into consideration its voltage, frequency, reliability, safety, environmental, and service quality requirements, as well as its existing contractual obligations.

In The Matter of the Amendment of Chapter 4901:1-11 of the Ohio Administrative Code, Case No. 94-1792-EL-ORD, Entry at Appendix Rule 4901:1-11-02(A) (January 16, 1997) (hereinafter "EFC Rule Entry"). However, the MP auditor in this proceeding has recognized that this is not necessarily how unregulated utilities would operate and the practical difficulties it has posed in its review:

> What may be good for a deregulated utility, however, is not clearly ideal for a regulated one. At a minimum, the current mode of operation is extremely difficult to audit. This problem was compounded during the audit period by on-going changes in how the FPP was to be formulated. Second, as part of the regulatory

> compact, utilities recover their reasonable costs which traditionally have been viewed as those which minimize costs over the long-term. It is not clear that a deregulated utility has the same objectives. CG&E acknowledged, for example, it was looking to buy short on fuel for native customers because of the regulatory uncertainty and the four-year RSP time horizon. There is a protocol in place that specifically states that SO^2 emission allowances are only to be bought one year out for native customers, while there is no restriction on non-native.

Commission Ordered Exhibit 1 and 1A at 1-5.

Furthermore, not only is there difficulty in making a determination of what costs are appropriate as a result of the practical differences of how the unregulated versus regulated company may operate, but the analysis and final determination of what the company can recover in the present circumstances is also hindered by the question of how certain costs would be allocated to the appropriate consumers and between business units with sometimes competing objectives. For example, when the management performance auditor, Mr. Schwartz, was asked about CG&E's purchase of emission allowances prior to the RSP, he agreed that when purchasing those allowances CG&E did not make a distinction between wholesale and retail, competitive or noncompetitive markets inasmuch as it was all one bank of allowances because there was only one market for electricity. Tr. Vol. I at 110 (Unredacted and Redacted). The lack of transparency in electric markets combined with market participants that are involved in numerous competitive and non-competitive services through various regulated and non-regulated business units dispatched to maximize the profits of a common owner create limitless accounting, financial and operational opportunities to attempt to defy the public interest. History tells us that profit-maximizing firms will face strong incentives to exercise their discretion in favor of allocating or assigning costs to,

and benefits away from, regulated businesses and their captive (*de facto* or *de jure*) customers to enhance margins available from business units obligated to earn money the old fashioned way (by earning it). While regulators may be able to eventually unpeel the onion's layers, regulation is ill-equipped to operate to proactively detect risks of injury or implement defense measures prior to such injury. Retail customers and, at times, utility shareholders, are increasingly put in harm's way.

The financial auditor in this proceeding, Mr. Smith, also acknowledged that transactions regarding emission allowances would require some Commission determination and guidance for a proper FPP analysis. Tr. Vol. I at 121, 124 and 128 (Unredacted and Redacted). Mr. Smith explained the limitations associated with not having clearly defined rules in his response to CG&E when asked whether or not he audited CG&E's costs in 2004:

> In terms of, you know, the direction, we got some general direction which was basically this is supposed to be "EFC like," you know, use the guidance to the extent it applies, but, you know, at the same time recognize that we're in a different environment. This is not really an EFC, it's a different type of rate. But it's supposed to still be "EFC like."

Tr. Vol. I at 131 (Unredacted and Redacted).

The problem of not having clearly defined rules regarding recovery for fuel and purchased power in a world where the Commission has had to enact some regulatory oversight in what is supposed to be an unregulated market has become clear in this case. For example, CG&E witness Esamann stated during cross examination that CG&E's goal is to maximize the value of its generating asset portfolio for its shareholders and at the same time keep its costs at the lowest level for CG&E's

customers. Tr. Vol. II at 69 (Unredacted and Redacted). CG&E's intention is admirable; however, the intention appears to have fallen short inasmuch as such a goal would have resulted in, among other things, CG&E allocating the benefits of the zero cost SO^2 emission allowances and gains from its coal hedges to all of its customers. Commission Ordered Exhibit 1 and 1A at 1-11 through 1-12.

Indeed, the matter of how exactly CG&E was to treat its coal hedging opportunities appears to have created some internal confusion for CG&E as well inasmuch as the financial auditor noted that in CG&E's first two quarterly FPP filings, CG&E did in fact credit certain coal transaction margins against fuel costs, but that those credits were later reversed in subsequent filings. Tr. Vol. I at 123 (Redacted and Unredacted). CG&E witness Esamann, however, indicated that the credit reversal occurred as a result of CG&E's realization that the credits contradicted its monetization criteria described in his supplemental testimony (Company Exhibit 4 at 8; Company Exhibit 4 at 8). Tr. Vol. II at 50 (Redacted and Unredacted). These criteria, however, are not articulated in any company policy, and were committed to writing only when asked to do so by the auditor. Tr. Vol. II at 51, 59 (Redacted and Unredacted).

Nonetheless, under a strict application of the EFC rules, the confusion of whether and how to allocate benefits such as these would not have been an issue. For example, despite the general directive that utilities should make purchases and utilize the emission allowance market to minimize costs,[1] the EFC rules also contained specific directives for utilities to allocate emission allowance costs between jurisdictional and

[1] EFC Rule Entry Appendix, Rules 4901:1-11-02, 4901:1-11-09(2)(d), and 4901:1-11-10(F)(2) Ohio Administrative Code.

non-jurisdictional customers.[2] Thus, it appears that in order for an evaluation of the FPP to be "EFC-like," such an evaluation would necessarily include an investigation of whether the company properly allocated the benefits of its coal hedging and emission allowances and sales, in conjunction with the evaluation of whether or not the company properly procured low-cost fuel.

Such an analysis apparently presents an inconsistency for CG&E, however, as CG&E witness Esamann indicated that one of the reasons that it would be inappropriate for the Commission to review or allocate coal hedges or emission allowances held by CG&E during the market development period is because, as an unregulated utility, the risks of creating margins and a market rate of return falls to CG&E through management of costs, assets and market risks. Mr. Esamann went on to say that, as such, the benefits during that period would not be properly allocated to ratepayers. Company Exhibit 3 at 5; Company. Exhibit 4 at 5. This fundamental debate occurred throughout the evidentiary hearing during cross-examination of witnesses for the Commission, Staff and CG&E.

Thus, the only real clear point made throughout this proceeding is that there are no rules for utilities to follow or for the consumers to rely upon to ensure that the components that are imbedded within the approved RSPs (such as the FPP in this case) will help ensure that consumers pay just and reasonable rates. While Ohioans continue to move forward in what is supposed to be an unregulated electricity market, the state of the market itself is causing the participants and regulators to back-peddle into a re-regulated regime, dangerously placing reliance upon traditional rules that are

[2] *Id.* at Rule 4901:1-11-04(c) and 4901:1-11-06, Ohio Administrative Code.

no longer in place or upon concepts that lack detail essential for constructive implementation.

III. CONCLUSION

Given the obvious difficulties presented in this proceeding, IEU-Ohio recommends that whatever the outcome here, and in view of ongoing issues concerning the maturation (or lack thereof) of the wholesale electric market and other stresses affecting the retail and wholesale markets, the Commission should take this opportunity to decide which direction it needs to take to ensure that just and reasonable electric rates in Ohio don't become a thing of the past. IEU-Ohio suggests that the Commission can achieve this objective by appropriately employing the tools that it does have to develop a long term plan to eliminate the mismatch between expectations held at the time when Ohio's electric restructuring legislation was adopted and the actual results since. In the event the Commission finds itself without the proper authority to develop such a plan, the Commission should request guidance from the General Assembly.

Respectfully Submitted,

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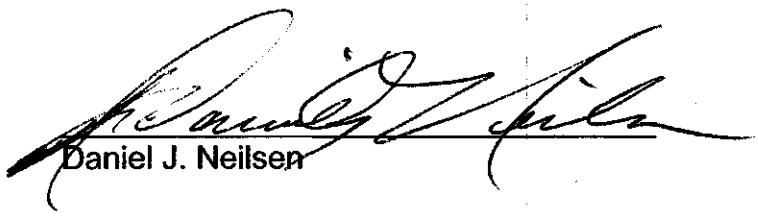
CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing Post-Hearing Brief of Industrial Energy Users-Ohio was served upon the following parties of record this 18th day of November, 2005.



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