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BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

FILE

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In the Matter of the Application of Columbus Southern Power Company and Ohio Power Company for Authority to Establish a Standard Service Offer Pursuant to § 4928.143, Ohio Rev. Code, in the Form of an Electric Security Plan.	:	Case Nos. 11-346-EL-SSO 11-348-EL-SSO
In the Matter of the Application of Columbus Southern Power Company and Ohio Power Company for Approval of Certain Accounting Authority.	:	Case Nos. 11-349-EL-AAM 11-350-EL-AAM

PREFILED TESTIMONY OF TIMOTHY W. BENEDICT

ON BEHALF OF THE STAFF OF
THE PUBLIC UTILITIES COMMISSION OF OHIO
ENERGY &ENVIRONMENT DEPARTMENT
MARKET ANALYSIS & PLANNING DIVISION

STAFF EX. ___

August 4, 2011

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1. Q. Please state your name and business address.

A. My name is Timothy W. Benedict. I am employed by the Public Utilities Commission of Ohio, 180 E. Broad St, Columbus, OH 43215.

2. Q. What is you current position at the Commission?

A. I am a Utility Specialist in the Division of Planning and Market Analysis, Department of Energy and Environment. My responsibilities include economic analysis of wholesale and competitive markets, demand forecasting and resource planning.

3. Q. Please summarize your educational background and work experience.

A. I received a B.A. in Economics from the University of Vermont and a M.A. in Economics from Cleveland State University. I have been employed by the Staff of the Public Utilities Commission of Ohio since December 2009.

4. Q. What is the purpose of your testimony?

A. The purpose of my testimony is to address the Companies' proposed POLR (Provider of Last Report) rider.

5. Q. What is your understanding of the risks identified by the Companies as comprising the POLR obligation?

A. The Companies identify two risks that comprise the POLR obligation, migration risk and return risk. Migration risk refers to the risk that customers can forego SSO generation service at any time to take service from a CRES provider. Return risk refers to the risk that customers who have switched may return to the Companies' SSO at any time. The Companies claim that there is a definite and significant cost associated with providing this flexibility or "optionality" for which they must be adequately compensated.

6. Q. Do you believe that the Companies have properly defined the nature of the POLR obligation?

A. No. It is my opinion that the POLR obligation includes only the risks associated with the possibility that customers may return to the SSO price at any time, which is the risk identified as the "return risk". While the return risk is related to migration risk, the migration risk itself simply reflects the possibility that customers may take advantage of the opportunity afforded to them by law to shop for generation service. What the Companies have identified as "migration risk," or shopping risk, reflects a risk that exists for all firms operating in a competitive market. The return risk, however, is a unique responsibility in that the EDU is obligated to stand ready to provide generation service to all customers at any time, and it is this risk which comprises the POLR obligation. The Companies have identified the return risk as comprising 12% of the total POLR cost in the proposed constrained model, valued at \$0.34 / MWh.[1]

7. Q. What costs could the Companies incur as a result of their POLR obligation?

A. Should a customer return to SSO service, it is likely because market prices have risen above the ESP price, creating an economic incentive for customers who have already switched generation providers to return to SSO service. The Companies would then incur any incremental capacity and energy costs associated with serving these customers.

8. Q. Do the Companies have the opportunity to recover such costs through existing rate mechanisms?

A. Yes. It is my understanding that any increase necessary for incremental fuel or purchase power to serve a returning customer could be collected through the FAC rider. Therefore, the Companies are not fully exposed to the risks associated with serving returning customers in a scenario where market prices are above the ESP price. Alternatively, returning customers could be required to pay a market-based rate in lieu of the SSO rate,

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1 *In re Columbus Southern Power and Ohio Power Company*, Case No. 11-346-EL-SSO, *et al.* (*2011 ESP Cases*) (OCC RPD-026 at Attachment 1).

effectively mitigating the risk to the Companies of providing standby service.

9. Q. What is your understanding of the mechanism by which the Companies propose to value the POLR obligation?

A. The Companies have proposed to value the POLR obligation using the Black model, which is a mathematical model used to derive the theoretical value of a financial option. An option is the right, but not the obligation, to buy or sell an asset at a specified price. The Black model is a variant of the more widely recognized Black-Scholes model, and is used when the model is applied to futures contracts. In this context the model calculates, on an a priori basis, the expected value to customers of the option to shop, as well as the option to return to SSO rates. The Companies claim that this value is equal to the cost to the Companies of providing the optionality, and is therefore the proper level of collection. A particularly troubling extension of this logic is that by setting the POLR rate equal to the value of the optionality to customers, the Companies are essentially extracting from customers the entire economic value afforded to them by the right to shop for a generation supplier.

10. Q. Do you believe that the Black model as presented by the Companies will result in an accurate valuation of the optionality available to customers?

11. A. The Black model, like any other model, must make certain limiting assumptions in order to achieve mathematical precision. The result may be that it does not fully reflect the specific situation it is intended to address, as the model is insufficiently equipped to account for the various factors that influence actual customer behavior.

For example, the model assumes that there are no transaction costs associated with exercising the option, which implies that all customers will switch in each and every instance in which the option is "in the money." This simplifying assumption is likely violated in reality for a number of reasons. The Companies seem to have acknowledged that the model is subject to certain sources of error and have "continued to refine and improve the option model."[2] This lead to the development of the "constrained model," which accounts for tariff-based switching constraints that limit the value of the option. Nonetheless, in reviewing the use of the model in prior years, the limited evidence that exists seems to indicate that the shopping behavior and attendant risks predicted by the model simply did not materialize.

12. Q. Does this conclude your testimony?

A. Yes, it does.

[2] *2011 ESP Cases* (Direct Testimony of Laura J. Thomas at 13) (January 27, 2011).

PROOF OF SERVICE

I hereby certify that a true copy of the foregoing **Prefiled Testimony of Timothy W. Benedict,** submitted on behalf of the Staff of the Public Utilities Commission of Ohio, was served by regular U.S. mail, postage prepaid, or hand-delivered, upon the following Parties of Record, this 4th day of August, 2011.

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