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BEFORE

THE PUBLIC UTILITIES COMMISSION OF OHIO

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In the Matter of the Application of )  
 The Cincinnati Gas & Electric Company )  
 to Modify Its Non-Residential Generation )  
 Rates to Provide for Market-Based ) Case No. 03-93-EL-ATA  
 Standard Service Offer Pricing and to )  
 Establish an Alternative Competitively-Bid )  
 Service Rate Option Subsequent to Market )  
 Development Period. )

In the Matter of the Application of )  
 The Cincinnati Gas & Electric Company for )  
 Authority to Modify Current Accounting ) Case No. 03-2079-EL-AAM  
 Procedures for Certain Costs Associated )  
 With the Midwest Independent Transmission )  
 System Operator. )

In the Matter of the Application of )  
 The Cincinnati Gas & Electric Company )  
 For Authority to Modify Current Accounting )  
 Procedures for Capital Investment in its )  
 Electric Transmission and Distribution ) Case No. 03-2081-EL-AAM  
 System Case No. 03-2080-EL-ATA )  
 And to Establish a Capital Investment )  
 Reliability Rider to be Effective after the )  
 Market Development Period. )

SUPPLEMENTAL TESTIMONY

OF

NEIL H. TALBOT  
Synapse Energy Economics, Inc.

ON BEHALF OF  
THE OFFICE OF THE OHIO CONSUMERS' COUNSEL

One Columbus, 10 West Broad St., Suite 1800  
Columbus, OH 43215  
(614) 466-8574

DATE: MAY 26, 2004

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*DATE: MAY 26, 2004*

1 **Q1. PLEASE STATE YOUR NAME, OCCUPATION AND ADDRESS.**

2 **A1.** My name is Neil H. Talbot. I am an economic and financial consultant affiliated  
3 with Synapse Energy Economics, Inc. My business address is 22 Pearl Street,  
4 Cambridge MA 02139.

5  
6 **Q2. ARE YOU THE SAME NEIL H. TALBOT WHO PREPARED DIRECT**  
7 **TESTIMONY IN THIS MATTER?**

8 **A2.** Yes.

9  
10 **Q3. WHAT IS THE PURPOSE OF YOUR SUPPLEMENTAL TESTIMONY?**

11 **A3.** My supplemental testimony responds to certain points made by Mr. Rose in his  
12 Supplemental Direct Testimony dated May 20, 2004 and addresses a few issues  
13 raised by the stipulation entered into in these cases (“ERRSP Stipulation”).

14  
15 **Q4. WHAT POINTS DO YOU ADDRESS REGARDING THE TESTIMONY OF**  
16 **CG&E WITNESS ROSE?**

17 **A4.** Mr. Rose’s Supplemental Direct Testimony contains a recalculation of prices under  
18 the Competitive Market Option Market Based Standard Service Offer (CMO  
19 MBSSO). The recalculation is undertaken to show that prices under the latest  
20 Electric Reliability and Rate Stabilization Plan (“ERRSP Stipulation Plan”) will not  
21 be so low as to be predatory and unreasonable. The CMO MBSSO, originally  
22 proposed in January 2003 and re-presented unchanged in January 2004, was the  
23 primary focus of my Prepared Testimony. Mr. Rose’s price recalculation effectively

1 undermines his own earlier presentation of the CMO MBSSO by showing that his  
2 pricing estimates are arbitrary and subjective.

3  
4 **Q5. WHY DO YOU SAY THAT THE PRICING ESTIMATES IN THE CMO**  
5 **MBSSO ARE "ARBITRARY AND SUBJECTIVE"?**

6 **A5.** Mr. Rose's Supplemental Direct Testimony shows his concern that if his previously  
7 calculated CMO MBSSO prices are much higher than the proposed ERRSP  
8 Stipulation Plan prices, the earlier calculations would suggest that the ERRSP  
9 Stipulation Plan prices are predatory and/or would undercut competitive CRES  
10 offerings. In using CMO MBSSO prices for his comparison purposes, which  
11 supposedly represent CRES prices, Mr. Rose attempts to show that they are *not*  
12 higher than proposed ERRSP prices. Accordingly, he makes five major downward  
13 adjustments to his earlier estimates that undermine the credibility of his price  
14 calculation methodology.

15  
16 **Q6. WHAT ARE THESE ADJUSTMENTS?**

17 **A6.** The first adjustment is a reduction of power prices to reflect 2003 prices as opposed  
18 to 2004 prices. This adjustment does not in and of itself suggest that MBSSO  
19 pricing is too high or too low. What it does show, however, is that it is volatile. By  
20 building in forward prices that can change significantly from one year to the next, as  
21 I argued in my Prepared Testimony, Mr. Rose's MBSSO proposal would not satisfy  
22 the Commission's criterion of rate certainty. Mr. Rose's latest calculations in his  
23 Direct Supplemental Testimony support my earlier argument.

1 **Q7. WHAT ARE MR. ROSE'S OTHER ADJUSTMENTS"?**  
2 **A7.** Mr. Rose lists three other adjustments, and there is an additional one that he does  
3 not initially list but which he refers to in passing. Taken together, these adjustments  
4 show how arbitrary the proposed MBSSO pricing would be, and how, as originally  
5 presented, it was "padded" so as likely to be on the high side. Again, by high I mean  
6 high in relation to CRES prices or to the Company's costs of acquiring power on the  
7 competitive market. The four adjustments are as follows: 1) Mr. Rose switches from  
8 block to non-block pricing, 2) he uses a narrower operating risk margin, 3) he uses a  
9 lower supply management fee, and 4) he also mentions that he drops his proposed  
10 "covariance" adjustment (i.e., he assumes zero "covariance").

11  
12 **Q8. DID YOU CRITICIZE THESE FOUR FEATURES OF MR. ROSE'S EARLIER**  
13 **VERSION OF THE CMO MBSSO?**

14 **A8.** Yes, I strongly criticized all of these features in my Prepared Testimony.

15  
16 **Q9. PLEASE DISCUSS BRIEFLY THE SWITCH FROM "BLOCK TO NON-**  
17 **BLOCK PRICING."**

18 **A9.** What Mr. Rose proposed in his earlier MBSSO presentation was to use block on-  
19 peak pricing for those customers for whom load shape estimates were not available.  
20 He now assumes, without providing any basis, that there is "greater load shape  
21 information."

22

1 **Q10. PLEASE DISCUSS MR. ROSE'S PROPOSED SUBSTITUTION OF A 7%**  
2 **OPERATING RISK MARGIN FOR HIS ORIGINAL 13.4%?**

3 **A10.** The operating risk margin estimate was one of the most serious flaws of Mr. Rose's  
4 original proposal. His original 13.4% proposal was based primarily on all-industry  
5 average data from Value Line. It should have been clear that the power retailing  
6 industry would be very different from the average of industries. The operating  
7 margin -- being comprised of profits plus debt interest plus depreciation plus taxes --  
8 reflects mostly return on capital. Mr. Rose may have had in mind the risk margin for  
9 the power *generation* industry, but the appropriate business activity for his CMO  
10 MBSSO calculations should be the retailing marketing business that operates on a  
11 smaller margin. The generation risk margin in his analysis would already be  
12 included in the wholesale price of power. Value Line estimates a ten-year average  
13 7.4% margin for retail stores (see OCC-POD-03-002 attached as part of my  
14 Supplemental Testimony). I will turn to the supply management fee next in this  
15 testimony.

16

17 **Q11. PLEASE COMMENT ON MR. ROSE'S REDUCTION OF THE "SUPPLY**  
18 **MANAGEMENT FEE" FROM 10% TO 4%.**

19 **A11.** Mr. Rose never claimed that there was a sound basis for his original 10% estimate,  
20 and I think this arbitrary adjustment shows that there was none.

21

22

1 **Q12. WHY HAS MR. ROSE DROPPED HIS COVARIANCE ADJUSTMENT?**

2 **A12.** It is not clear why he has now set covariance to zero. He argued at great length that  
3 positive covariance was a factor that should be taken into account, and in principle it  
4 is true that the price of power is likely to be higher when customer loads are higher,  
5 which is what the covariance adjustment was supposed to reflect. However, the  
6 difficulty with his proposal was that it was not clear that the covariance adjustment  
7 did not overlap or duplicate other pricing features. The possibility of overlap and  
8 duplication was a general problem with his overly complex CMO MBSSO proposal.

9  
10 **Q13. DO YOU OBJECT TO STANDARD SERVICE OFFERS THAT ARE BOTH**  
11 **TOO HIGH AND TOO LOW?**

12 **A13.** A standard service offer that is too high adds to the profitability of marketers, but  
13 the entry of marketers into a profitable market is not an end in itself. Market entry is  
14 desirable only as a means to greater efficiency and lower consumer prices. While  
15 the Commission's criteria include the advancement of competition, I don't think the  
16 way to achieve that is to set standard offer prices higher than is needed. One reason  
17 that this would be harmful to consumers is that, in the presence of non-price barriers  
18 to competition and customer inertia built on lack of trust in the institutions that have  
19 instituted electric choice, consumers would be constrained to take expensive  
20 standard offer service. Standard service offers can also be inappropriately lowered  
21 to restrict competition by imposing non-bypassable charges to cover the generation  
22 costs (or more than the cost of generation) of the company that owns the distribution  
23 lines. In the absence of rate of return regulation, efficiency and reasonable consumer

1 prices are served when generation prices are set by the marketplace rather than by  
2 regulatory command.

3

4 **Q14. PLEASE STATE YOUR CONCLUSIONS.**

5 **A14.** As I have show, in a single paragraph of his Supplemental Direct Testimony (p.3, 1<sup>st</sup>  
6 paragraph), Mr. Rose totally undermines the MBSSO edifice he created last year. He  
7 cuts the price for DM consumers by 47.5% from an estimated 6.25 cents/kWh to  
8 3.28 cents/kWh. Apart from the difference in wholesale prices between 2003 and  
9 2004, his only explanation is that "[t]hese lower margins and fees could come about  
10 via lower costs, lower risks or greater competition." (Supplemental Direct  
11 Testimony at 3, lines 5-6). I believe the enormity of this change supports my view  
12 that the proposed MBSSO structure cannot be relied upon to produce just and  
13 reasonable rates. Nor should it be used, as Mr. Rose does in his Supplemental  
14 Testimony, to create a competitive pricing benchmark against which to test the  
15 reasonableness of ERRSP pricing.

16

17 **Q15. WHAT IS YOUR RECOMMENDATION TO THE COMMISSION?**

18 **A15.** I reiterate my recommendation that a MBSSO rate based upon CG&E's costs of  
19 acquiring power in the wholesale market, plus an appropriate allocation of other  
20 costs for retail service, would provide a better basis for a standard offer rate. This  
21 recommendation is made in the context that the primary manner of charging  
22 customers who do not choose a generation supplier is by means of a competitive  
23 bidding process, as provided by the Commission's rules, and that the generating



1 plants of CG&E be transferred to a separate entity as provided for in the CG&E ETP  
2 case. The ERRSP Stipulation does not provide for either of these conditions to  
3 exist, and should be rejected in order to provide for market based rates based on true  
4 competition.

5

6 ***Q16. DOES THAT CONCLUDE YOUR SUPPLEMENTAL TESTIMONY?***

7 ***A16.*** Yes, it does.

**Ohio Consumers' Counsel Second Set Production of Documents**  
**CG&E Case No. 03-93-EL-ATA**  
**Date Received: April 2, 2004**  
**Response Due: April 12, 2004**

**OCC-POD-03-002**  
**Page 1 of 2**

**REQUEST:**

2. Referring to page 19 of CG&E Application Exhibit 1 of the 1/9/03 Application in Case No. 03-93-EL-ATA in which the Company seeks a 13.4% Operating Risk Adjustment as part of its MBSSO that is derived from a Value Line reported "average across all industries of 16.65%" less 3.25% for Sales, General and Administrative costs, please provide the workpapers, calculations and documents supporting this proposed adjustment, including any documentation from Value Line.

**RESPONSE:**

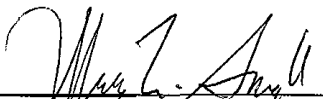
The attached table provides the ten-year average operating margin using data extracted from the Value Line database for all industries. The numbers have changed slightly from the original filing, but the net number is still the same. Average operating margin of 16.5% minus 3.1% for the electric utility (central % sales, general, & administrative costs) produces 13.4%.

-continued-



**CERTIFICATE OF SERVICE**

It is hereby certified that a true copy of the foregoing Supplemental Testimony of Neil H. Talbot was served via electronic mail, this 26th day of May, 2004.

  
\_\_\_\_\_  
Jeffrey L. Small

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