

BEFORE

THE PUBLIC UTILITIES COMMISSION OF OHIO

In The Matter of the Application of)	
Duke Energy Ohio, Inc. for an)	Case No. 07-589-GA-AIR
Increase in Gas Rates)	
)	
In the Matter of the Application of)	
Duke Energy Ohio, Inc. for Approval)	Case No. 07-590-GA-ALT
of an Alternative Rate Plan for its)	
Gas Distribution Service)	
)	
In the Matter of the Application of)	
Duke Energy Ohio, Inc. for Approval)	Case No. 07-591-GA-AAM
to Change Accounting Methods)	

DIRECT TESTIMONY OF

C. JAMES O'CONNOR

ON BEHALF OF

DUKE ENERGY OHIO, INC.

_____	Management policies, practices, and organization
<u> x </u>	Operating income
_____	Rate Base
_____	Allocations
_____	Rate of return
_____	Rates and tariffs
_____	Other

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INDEX

Testimony addressing incentive compensation expense.

C. JAMES O'CONNOR DIRECT

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I. INTRODUCTION

1 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

2 A. My name is C. James O'Connor, and my business address is 139 East Fourth
3 Street, Cincinnati, Ohio 45202.

4 **Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?**

5 A. I am employed by the Duke Energy Corporation ("Duke Energy") affiliated
6 companies as Vice President, Human Resources.

7 **Q. PLEASE SUMMARIZE YOUR EDUCATION.**

8 A. I graduated from Indiana University with a Bachelor of Science degree in
9 business management. I also earned a Master of Art degree in Executive
10 Development from Ball State University. I have also had further education at
11 Purdue University in management studies, at the University of Wisconsin in labor
12 studies and from Ball State University in economic development.

13 **Q. PLEASE SUMMARIZE YOUR WORK EXPERIENCE.**

14 A. I joined PSI Energy, Inc. in 1976 as an Energy Consultant in Field Operations,
15 Transmission and Distribution, Electric Operations. I advanced through various
16 positions of increasing responsibility in sales, economic development, labor
17 relations, safety, district management in field operations, transmission and
18 distribution, and human resources. I was named to my current position of Vice
19 President, Human Resources in April 2006.

20 **Q. PLEASE DESCRIBE YOUR DUTIES AS VICE PRESIDENT, HUMAN**
21 **RESOURCES.**

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1 A. I am responsible for the Human Resources function for Duke Energy's Strategy
2 Policy and Regulatory Business Unit. My responsibilities generally include
3 accountability to the business unit for the delivery of all Human Resource
4 functions. To this end, Duke Energy has two Human Resource organizations that
5 partner to provide an end product. The two departments and their responsibilities
6 are Corporate Human Resources, which performs the strategic design of Human
7 Resource Compensation and Benefit programs and Human Resources Services,
8 which includes the Strategic design of Labor and Employee Relations, Inclusion
9 and Workforce Strategy, Staffing Services, Organizational Development and
10 Business Partners. The Business Partner is responsible to represents the business
11 unit human resources needs to the two Human Resources organizations. Working
12 with these Human Resources organizations, I am responsible for the following
13 services: compensation and benefits, employee and labor relations, staffing and
14 recruiting, training and organizational development, inclusion strategies and
15 diversity programs, workforce planning and measurement, succession planning,
16 leadership development and employee and retiree communications relating to the
17 Strategy, Planning and Regulatory Business Unit.

18 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS**
19 **PROCEEDING?**

20 A. I respond to the recommendation of the Ohio Consumers' Counsel witness Mr.
21 Steven B. Hines to eliminate incentive compensation expense from the test year
22 expense.

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1 **II. COMPENSATION PHILOSOPHY**

2 **Q. PLEASE DESCRIBE THE BASIC COMPENSATION PHILOSOPHY OF**
3 **DUKE ENERGY AFFILIATED COMPANIES, INCLUDING DUKE**
4 **ENERGY OHIO, INC. (“DE-OHIO”).**

5 A. The Companies’ basic compensation philosophy is to design a compensation
6 program consisting of base salary and annual incentives that provides employees
7 with an opportunity to earn total compensation competitive with the market. This
8 philosophy supports the Companies’ goal to attract, retain and motivate the
9 caliber of employees with the education, experience, judgment and skills
10 necessary to carry out the responsibilities of the positions that the employees are
11 hired to fill. The Companies’ general compensation strategy is to provide a
12 compensation package consisting of a combination of fixed and variable pay, using
13 base salary, short-term incentives and long-term incentives; these components, in
14 the aggregate, are targeted to deliver total compensation at the 50th percentile of
15 the applicable peer group. However, if Duke Energy delivers superior
16 performance, our compensation program is designed to provide total
17 compensation above market median based on performance, and conversely, if
18 Duke Energy's performance should decline, then total compensation is designed
19 to decline to a level commensurate with such performance.

20 The Companies adopted this compensation strategy in order to attract,
21 retain and motivate the employee talent required to deliver superior performance.
22 This strategy emphasizes performance-based compensation that balances rewards
23 for both short-term and long-term results and which aligns the employees’

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1 interests with the long-term success of Duke Energy and its subsidiaries,
2 including DE-Ohio.

3 **Q. PLEASE DESCRIBE HOW THE COMPANIES STRUCTURE THEIR**
4 **COMPENSATION PROGRAMS.**

5 A. The Companies' compensation programs consist of a base pay component and an
6 incentive pay component. The base pay component is a set amount, reviewed by
7 management at least annually, and established at a level that: (1) provides
8 competitive compensation based on the nature and responsibilities of the
9 employee's position; and (2) is fair relative to the pay for other similarly situated
10 positions in the organization. The incentive pay component is variable and is at
11 risk to the employees. Incentive pay is generally linked to the accomplishment of
12 specific goals established in advance for the individual employee, his or her
13 business unit, and/or the corporation. The purpose of incentive pay is: (1) to
14 encourage employees to perform at a high level in order to accomplish specific
15 objectives intended to ensure safe, reliable and economical utility service to our
16 customers and to ensure their business unit's and the corporation's overall
17 success; and (2) to constitute a component of a compensation package that is
18 competitive with the market.

III. INCENTIVE PAY PROGRAMS

19 **Q. PLEASE DESCRIBE THE COMPANIES' INCENTIVE PAY PROGRAMS.**

20 A. The Companies' major incentive pay programs are: (1) the Duke Energy
21 Corporation Annual Incentive Plan (referred to for convenience as "Short-Term
22 Incentive Plan" or "STI"); (2) the Cinergy Corp. Union Employees' Incentive

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1 Plan ("UEIP"); and (3) the Duke Energy Corp. 1998 Long-Term Incentive Plan
2 ("LTI").

3 **Q. PLEASE DESCRIBE THE STI PLAN.**

4 A. The STI plan is a short-term incentive plan that allows employees to receive cash
5 payments if certain pre-determined performance goals are attained during the
6 relevant calendar year. The STI plan is available to exempt and non-exempt, non-
7 union employees of DE-Ohio, and the service companies who perform work for
8 DE-Ohio, who do not participate in another incentive plan. The purpose of the
9 annual incentive plan is to attract, retain and motivate employees; enhance
10 teamwork and high levels of achievement; and to facilitate the accomplishment of
11 specific corporate, business unit and individual goals.

12 At the beginning of each calendar year, corporate, business unit and
13 individual performance goals are established for the annual plan, and a thorough
14 review is performed at the end of the calendar year to determine the achievement
15 levels for each performance goal. The Compensation Committee of the Duke
16 Energy Board of Directors ("Compensation Committee") approves the corporate
17 performance goal at the beginning of each calendar year and certifies the payout
18 level achieved for such goal at the end of the calendar year.

19 The performance goals are the objectives that the corporation, business
20 unit and individual employees must attain in order for the employees to receive
21 payment under the annual incentive plan. The performance goals may consist of
22 a combination of corporate, business unit and individual goals. The corporate
23 performance goal must be an objective measure of the corporation's performance,

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1 efficiency or profitability. Business unit goals are related to specific financial and
2 operational objectives of the unit such as safety, reliability and cost of service.
3 Individual goals are set cascading down from and supporting the business unit
4 and corporate goals so that everyone works towards common goals and
5 objectives. The Company's objective is to balance corporate goals and individual
6 goals appropriately so employees can have a direct impact relative to their goals.

7 All applicable goals are weighted, with a possible range of scores from
8 zero to 3.0. Once an achievement level is determined, the achievement level is
9 multiplied by the weighting assigned to each respective goal to determine an
10 overall payout level.

11 **Q. PLEASE DESCRIBE THE UEIP.**

12 A. The UEIP is available to union employees of DE-Ohio, and the service companies
13 who do not participate in another incentive plan. The UEIP is a short-term
14 incentive plan that allows union employees to receive cash payments if the
15 Company attains certain corporate performance goals or if their group attains
16 certain performance goals during a calendar year. The purpose of the UEIP is to
17 attract, retain and motivate employees, enhance teamwork and high levels of
18 achievement, and to facilitate the accomplishment of specific corporate and
19 business unit goals.

20 The UEIP award levels consist of a percentage of the employee's base and
21 overtime earnings, based on the following corporate and business unit
22 achievement levels:

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REGULATED BUSINESS UNIT	Award Levels (expressed as a percentage of earnings)		
	1	2	3
Corporate Measure	0.50%	0.75%	1.00%
Safety	If a union achieves the applicable safety goal, .5% is added to its members' incentive payouts; if a union fails to achieve this goal, 0% is added to its members' incentive payout.		
Customer Satisfaction/ Peak Equivalency	If a union achieves the applicable customer satisfaction goal or peak equivalency goal, .5% is added to its members' incentive payouts; if the union fails to achieve these goals, 0% is added to its members' incentive payouts.		
Total Incentive Opportunity	1.50%	1.75%	2.00%

As with the STI plan, the Compensation Committee of the Board of Directors approves the corporate performance goal and the level of corporate performance that will be associated with particular payout levels. At the end of the year, the Compensation Committee certifies the actual performance and payout level with respect to such corporate performance goal.

Q. PLEASE DESCRIBE THE LTIP AND LTI PLANS.

A. These plans pay equity-based compensation to leadership employees and non-employee directors in a manner that aligns their interests with the long-term interests of Duke Energy and its affiliates, including DE-Ohio. The purpose of the long-term incentive plan(s) is: (1) to assist in attracting, retaining and motivating executives by keeping the Companies' compensation package competitive; and (2) to align a portion of executive compensation with stakeholder interests by encouraging and enabling executives to acquire Duke Energy stock.

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1 **Q. WHEN DE-OHIO PREPARES ITS BUDGETS, WHAT ACHIEVEMENT**
2 **LEVEL DOES IT ASSUME FOR THESE INCENTIVE PLANS?**

3 A. The budget assumes that employees will reach the targeted performance
4 objectives. During the past few years, actual performance, as determined by the
5 Board of Directors during their annual review, has tended to exceed the targeted
6 performance levels. In my opinion, this demonstrates that incentive
7 compensation is effective at motivating superior performance by our employees.

8 It should be noted that the test year level of expenses for incentive
9 compensation only reflect the “target” levels. Traditional rate case principles
10 compel us to include only “normal” levels of expenses. Although incentive
11 compensation expenses may be higher than target in some years and lower than
12 target in others, the budget reflects only the “normalized” target expenses because
13 that is what we would expect in a normal year.

14 **IV. RECOVERY OF INCENTIVE COMPENSATION EXPENSE**

15 **Q. MR. HINES RECOMMENDS THAT \$1.9 MILLION OF DE-OHIO’S TEST**
16 **YEAR INCENTIVE COMPENSATION EXPENSE OF \$2,392,052 BE**
17 **ELIMINATED BECAUSE THIS AMOUNT IS TIED TO COMPANY**
18 **PROFIT AND DOES NOT BENEFIT CUSTOMERS. PLEASE RESPOND.**

19 A. I disagree with Mr. Hines. I recommend that DE-Ohio recover the entire amount
20 of its incentive compensation expense, including the amount tied to company
21 profit, because the portion of incentive pay tied to company profit benefits
22 customers as well as shareholders.

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1 **Q. HOW DOES THE PORTION OF INCENTIVE PAY TIED TO COMPANY**
2 **PROFIT BENEFIT DE-OHIO'S CUSTOMERS?**

3 A. Customers benefit from this portion of incentive compensation in several ways.

4 First, incentive pay is part of total compensation. The Companies'
5 incentive compensation philosophy is to target pay at the 50th percentile of peer
6 companies. If incentive pay were eliminated, DE-Ohio could not attract quality
7 employees because employees would seek employment at companies offering
8 higher total compensation. Without quality employees, all of DE-Ohio's
9 operations would suffer. Keep in mind that the greatest portion of incentive pay
10 is paid through the annual incentive plans that benefit all employees, not merely
11 executives.

12 Second, Duke Energy will be profitable only if DE-Ohio and the other
13 operating companies achieve their budget goals. DE-Ohio's budget balances: (1)
14 the need to make adequate capital investment to allow DE-Ohio to provide safe,
15 adequate and reliable service; and (2) the need for DE-Ohio to be profitable, so
16 Duke Energy shareholders have a reasonable opportunity to earn a fair return on
17 their investment. When DE-Ohio meets these budget objectives and is profitable,
18 this also results from managing costs effectively, and benefits customers by
19 avoiding rate increases.

20 Third, Duke Energy must be profitable in order to sustain a reasonable
21 stock price. If Duke Energy were not profitable, then investors would need to
22 earn higher returns to invest in the Company, and the Company would incur

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1 higher borrowing costs. This higher cost of capital would lead to higher utility
2 rates.

3 **Q. DID BLUE RIDGE CONSULTING SERVICES, INC., THE**
4 **COMMISSION'S INDEPENDENT FINANCIAL AUDITOR,**
5 **RECOMMEND THAT INCENTIVE PAY TIED TO COMPANY PROFIT**
6 **BE ELIMINATED FROM TEST YEAR EXPENSE?**

7 A. To my understanding, no they did not.

8 **V. CONCLUSION**

9 **Q. DOES THIS CONCLUDE YOUR PRE-FILED DIRECT TESTIMONY?**

10 A. Yes.

CERTIFICATE OF SERVICE

I certify that a copy of the foregoing Direct Testimony of C. James O'Connor was served on the following parties of record by electronic filing and by ordinary United States mail, postage prepaid, this 22nd day of February 2008.

/s/ John J. Finnigan, Jr.
John J. Finnigan, Jr.

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Summary: Testimony of C. James O'Connor electronically filed by ANITA M SCHAFER on behalf of Finnigan, John J. Mr.