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BEFORE

THE PUBLIC UTILITIES COMMISSION OF OHIO

In The Matter of the Application of Duke Energy Ohio for Approval of an Electric Security Plan	)))	Case No. 08-920-EL-SSO
In The Matter of the Application of Duke Energy Ohio for Approval to Amend Accounting Methods	)))	Case No. 08-921-EL-AAM
In the Matter of the Application of Duke Energy Ohio for Approval of a Certificate of Public Convenience and Necessity to Establish an unavoidable Capacity Charge(s)	)))))	Case No. 08-922-EL-UNC
In the Matter of the Application of Duke Energy Ohio for Approval to Amend its Tariffs	)))	Case No. 08-923-EL-ATA

DIRECT TESTIMONY OF

WILLIAM DON WATHEN JR.

ON BEHALF OF

DUKE ENERGY OHIO

July 31, 2008

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I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is William Don Wathen Jr. My business address is 139 East Fourth Street, Cincinnati, Ohio 45202.

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

A. I am employed by Duke Energy Corporation ("Duke Energy") affiliated companies as Director of Revenue Requirements.

Q. PLEASE SUMMARIZE YOUR EDUCATION AND PROFESSIONAL QUALIFICATIONS.

A. I received Bachelor Degrees in Business and Chemical Engineering, and a Master of Business Administration Degree, all from the University of Kentucky. After completing graduate studies, I was employed by Kentucky Utilities Company as a planning analyst. In 1989, I began employment with the Indiana Utility Regulatory Commission as a senior engineer. From 1992 until mid-1998, I was employed by SVBK Consulting Group, where I held several positions as a consultant focusing principally on utility rate matters. I was hired by Cinergy Services, Inc. in 1998, as an Economic and Financial Specialist in the Budgets and Forecasts Department. In 1999, I was promoted to the position of Manager, Financial Forecasts. In August 2003, I was named to my current position as Director of Revenue Requirements in the Rates Department.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THIS COMMISSION?

A. Yes. I have presented testimony on numerous occasions before this Commission and various other state, local, and federal regulators.

Q. PLEASE SUMMARIZE YOUR DUTIES AS DIRECTOR OF REVENUE REQUIREMENTS.

A. As Director of Revenue Requirements, I am responsible for the preparation of financial and accounting data used in the wholesale and retail rate filings for Duke Energy Ohio (DE-Ohio) and Duke Energy Kentucky (DE-Kentucky), petitions for changes in fuel and gas cost adjustment factors, and various other rate recovery mechanisms in Ohio and Kentucky.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. My testimony will address a number of items that are being proposed by the Company in its Electric Security Plan (ESP). The specific components I will be discussing include:

- Part B: Price-to-Compare Fuel & Purchased Power Rider (Rider PTC-FPP)
- Part B: System Resource Adequacy System Reliability Tracker (Rider SRA-SRT)
- Part B: Price-to-Compare Annually Adjusted Component (Rider PTC-AAC)
- Part D: Transmission Cost Recovery Rider (Rider TCR)
- Part E: Distribution Rider – Infrastructure Modernization Rider (Rider DR-IM)

II. FUEL & PURCHASED POWER - RIDER PTC-FPP

Q. DESCRIBE THE EXISTING RIDER FPP?

A. This rider has been in existence since January 1, 2005, for non-residential consumers and since January 1, 2006, for residential consumers. This rider was intended to allow the Company to recover incremental costs for certain components of its base generation price that had been frozen since 1999. It is only applicable to retail consumers who take generation service from DE-Ohio. Prior to deregulation, utilities in Ohio were allowed relatively timely recovery of costs for fuel, economy purchased power, and emission allowances.

Rider FPP essentially allows the Company to recover its current costs for these same items in a manner very similar to the methodology employed before deregulation. In the relatively short period of time since the Rider FPP has been introduced, the introduction of evolving wholesale markets of the Midwest Independent System Operator, Inc. (MISO), coupled with the continually evolving deregulation of retail markets in Ohio has resulted in the Rider FPP that we file on a quarterly basis today. A notable difference between the Rider FPP and the fuel cost recovery mechanism that existed prior to deregulation is the inclusion of congestion and losses.

Under MISO's Day 2 market, costs for congestion and losses are explicit components of the cost of power. Although these charges are billed by the regional transmission organization, these costs are directly attributable to generation. Consequently, they are included in the Rider FPP and not in the *transmission* cost recovery.

Due to the nature of the MISO energy markets, virtually all of the energy purchased by the Company are economy power purchases. DE-Ohio purchases its load requirements at the prevailing market price for power at any given time based on the prices established in the Day Ahead and Real Time energy markets. By definition this is 'economy' power and is included in Rider FPP.

Emission allowances for SO_2 are also included in Rider FPP following historical methods of recovery of these expenses. Environmental regulations require that DE-Ohio have enough emission allowances to offset the tons SO_2 emitted from our generation plants. DE-Ohio's generation portfolio is such that it must purchase allowances from the market to utilize its fleet. The costs for these SO_2 allowances attributable to the non-switching retail load are recovered in Rider FPP.

Q. WHY ARE COSTS FOR CONGESTION AND LOSSES INCLUDED IN THE FPP?

A. MISO includes congestion and losses as components of the energy prices established at the various pricing nodes throughout its footprint to incentivize the optimal use of generation throughout the system. The concept of congestion costs is not new. Prior to deregulation and the development of the MISO, relieving congestion in a transmission system typically meant that a utility may have to operate a generating unit out of economic merit to meet some system constraint (*e.g.*, reliability, voltage, *etc.*). Operating a generating unit "out of merit" meant that the utility's fuel costs were higher than would be the case if its generating fleet operated exclusively in order of lowest to highest cost. In this pre-MISO

paradigm, congestion costs were simply reflected as higher fuel costs. One could possibly carve out the magnitude of the congestion costs by attempting to quantify the difference in the actual fuel costs and what the fuel costs would have been if not for the constraints but that typically was not required.

Similarly, there is a direct nexus between losses and generation. Although the transmission system is obviously the cause of the losses (*i.e.*, electrical resistance in the wires means only a portion of the electricity produced reaches the ultimate consumer), the remedy is to *generate* enough electricity at the station to overcome the losses. Consequently, the cost of losses is borne at the generation level.

Because the costs of congestion and losses are both related more to generation than transmission, the Company elected to include these costs in the Rider FPP rather than its Rider TCR. The Commission approved this change in prior proceedings[1] and the Company proposes to continue this practice.

Q. ARE THERE ANY OTHER COSTS THAT ARE INCLUDED IN THE RIDER FPP THAT SHOULD BE ADDRESSED?

A. Yes. MISO allocates financial transmission rights (FTRs) to DE-Ohio which are intended to be used to mitigate the cost of congestion. Because these FTRs are related to congestion, we include this cost in the Rider FPP.

Finally, the Company hedges certain production costs (*e.g.*, coal, emission allowances, *etc.*) on behalf of its non-switching retail load in order to mitigate the impact of the uncertainty in price and availability of these assets. Occasionally,

the Company will engage in transactions to rebalance its positions which may result in gains or losses on these hedges. Because of the nature of these hedges and because this activity is done for the benefit of its non-switching retail consumers, the Company includes the net gains and losses on these transactions in the Rider FPP.

Q. PLEASE DESCRIBE ANY CHANGES BETWEEN DE-OHIO'S CURRENT RIDER FPP AND THE PTC-FPP PROPOSED AS PART OF ITS ELECTRIC SECURITY PLAN?

A. We are proposing three changes. The first change is to add the cost and/or benefit associated with NO_x emission allowances and any potential future allowances costs (*e.g.*, Hg, CO_2, *etc.*). The second change is to transform the Rider PTC-FPP from an incremental charge to a total charge for fuel, economy purchased power, and emission allowances. The last change is simply to include, as eligible costs, the energy portion of any purchases from renewable resources.

Q. WHY IS DE-OHIO PROPOSING TO INCLUDE EMISSION ALLOWANCES FOR NO_x AND OTHER POTENTIAL ALLOWANCES IN THE RIDER PTC-FPP CALCULATION FOR THE ELECTRIC SECURITY PLAN WHEN THESE WERE NOT INCLUDED IN PRIOR RIDER FPP FILINGS?

A. When Rider FPP was first conceived, as part of the Company's Rate Stabilization Plan (RSP), approved in Case No. 03-93-EL-ATA, *et al.*, DE-Ohio anticipated

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(...continued)

[1] See Commission Order in Case No. 03-93-EL-ATA, *et al.*, page 7, (December 20, 2006).

that it would have enough zero-cost NO_x emission allowances allocated from the Environmental Protection Agency (EPA) to meet its compliance obligations. Because of this situation, the Company did not deem it necessary, nor did it seek, recovery of NO_x allowance costs.

Compliance with NO_x emission regulations are expected to become significantly more onerous and, although the Company is relatively well positioned for compliance for the duration of the ESP, we believe it is appropriate to ask for recovery of any costs incurred for NO_x emissions during the ESP. These increasingly rigorous regulations combined with the uncertainty in the courts over various existing rules and potential new rules for carbon and mercury, for example, as discussed by DE-Ohio witness Charles R. Whitlock, add considerable risk to the Company in how it manages its generation assets.

Q. WILL THE COMPANY ONLY PASS THROUGH ADDITIONAL COSTS ASSOCIATED WITH EMISSION ALLOWANCES?

A. No. Following the same methodology we apply to the SO_2 emission allowances in the current FPP Rider, we will flow through to consumers any net gains attributable to the non-switching share of EAs sold with a vintage year of 2009 through 2011 in Rider PTC-FPP.

Q. EXPLAIN HOW YOU PROPOSE TO TRANSFORM THE RIDER PTC-FPP FROM AN INCREMENTAL CHARGE TO TOTAL RECOVERY.

A. In its present form, Rider FPP is calculated by computing the current price for the components included in the rider (*e.g.*, fuel, purchased power, EAs, *etc.*) and measuring that price against the price of the same components as they existed

when frozen in 1999. One component of the Company's current market-based standard service offer (MBSSO) is the generation price that was frozen in 1999. Included in that generation rate was 1.2453 ¢/kWh for fuel, economy purchased power, and SO_2 emission allowances. The proposed change, moving the fuel, power, and allowance costs components from the generation price to the PTC-FPP, will have no impact whatsoever on consumers' bills - it is merely a means toward the end of simplifying the Rider PTC-FPP calculation making the Electric Security Plan (ESP) pricing simpler and more transparent by aligning all of the variable generation charges in one bucket.

From an unbundling perspective, this proposal is sensible and practical. The Rider PTC-FPP will now be wholly representative of the contribution fuel, purchased power, and EAs have on the generation price; consequently, the cost of such commodities in the overall price will be highly visible to consumers.

Q. EXPLAIN THE CHANGE TO INCLUDE RENEWABLE RESOURCES IN THE PTC-FPP?

A. Arguably, this is not necessarily a change to the Rider PTC-FPP. DE-Ohio will include the energy charges associated with any renewable resources acquired contractually or that we build, to the extent the energy from those resources is assigned to retail load. Other than the designation of this energy as renewable, the eligibility of such energy costs in Rider PTC-FPP is no different than in the current Rider FPP.

Q. WILL THE TIMING OF THE RIDER PTC-FPP FILINGS BE THE SAME?

A. Yes. Consistent with our past practice and with the Commission's new rules for the ESP, the Company will continue to make quarterly filings for the Rider PTC-FPP. The Company will continue to make quarterly filings with a minimum of 30 days prior to the effective date of the updated Rider PTC-FPP prices. The first filing for the ESP period will be made on or before December 1, 2008, for the first quarter of 2009. Similarly, following past practice, we anticipate annual audits by the Commission and/or its delegates. We do propose, however, that, to the extent the Company is required to pay for outside auditors used by the Commission for auditing the Rider PTC-FPP, these costs be eligible for inclusion in the Rider PTC-FPP.

We will continue to true-up in the form of reconciliation adjustments in Rider PTC-FPP. Because so much of the cost items flowing through the Rider PTC-FPP are dependent on information from MISO, it will likely be necessary to continue making adjustments for multiple past periods.

Finally, the Company requests that the Commission recognize that the rapidly changing circumstances in the electric utility industry may require modifications to the Rider PTC-FPP calculation from time to time. To the extent such changes are necessary, the Company commits to work with the Staff to develop the appropriate means of incorporating such changes in a timely manner. The Company also proposes that the Commission explicitly acknowledge that, to the extent necessary and practicable, the Rider PTC-FPP can be updated in a manner necessary to minimize significant over- and/or under-recovery, and the resulting consumer rate shock, between filing periods. This proposal mirrors

language authored by the Commission Staff in its proposed rules for Transmission Cost Recovery, O.A.C. 4901-36-1, issued July 1, 2008.

Q. WILL THE RIDER PTC-FPP FILINGS CONTINUE TO BE AUDITED?

A. Yes. As has been the past practice, DE-Ohio will submit an annual audit of its Rider PTC-FPP, including a review of the calculations and managerial aspects of our practices, on or about June 1 of each year. The Company does request that, to the extent the Commission uses an outside auditor for its annual review, any cost billed to the Company for the use of this outside auditor be eligible for recovery in Rider PTC-FPP.

III. SYSTEM RESOURCE ADEQUACY- SYSTEM RELIABILITY TRACKER – RIDER SRA-SRT

Q. WHAT IS THE SYSTEM RELIABILITY TRACKER?

A. As with the Rider FPP, the system reliability tracker, or Rider SRT, has been in effect since January 1, 2005, for non-residential consumers and since January 1, 2006, for residential consumers. This rider provides the Company a means of recovering the costs of purchasing sufficient capacity to meet its load obligations including reserves. The only costs eligible for recovery in this rider are the costs of purchasing appropriate forms of capacity (*e.g.*, strips, options, *etc.*) necessary to maintain a 15% planning reserve margin. The existing Rider SRT is unavoidable for residential consumers and is only avoidable by only those non-residential consumers who contractually commit to certain conditions.

The Rider SRA-SRT is essentially an annual filing projecting costs for the coming year with quarterly updates as the year progresses. On or before

December 1st of a given year, the Company makes a filing indicating its expected Rider SRA-SRT costs and the proposed rates for recovery. Each successive quarter, we have more certainty as to the expected or actual cost of purchases and as to the amount of Rider SRA-SRT revenue collected. Consequently, each quarter we update the Rider SRA-SRT rates in order to minimize the likelihood of being substantially over- or under-collected for the year. Of course, it is virtually impossible to ensure that there is no over- or under-recovery; so, the Rider SRA-SRT also includes a reconciliation adjustment to make consumers and shareholders whole.

DE-Ohio witness Charles R. Whitlock describes the Company's plans for capacity purchases as part of its ESP.

Q. PLEASE DESCRIBE ANY DIFFERENCES BETWEEN DE-OHIO'S CURRENT RIDER SRT AND THE PROPOSED RIDER SRA-SRT?

A. Rider SRA-SRT will be nearly identical to prior years' Rider SRT filings. The rates and the reconciliation adjustment will be calculated in a manner consistent with prior filings. The only notable difference anticipated is that the Company will be presenting its capacity purchase plan for the entire term of the ESP rather than just one year at a time; however, this change has no impact on the calculation of Rider SRA-SRT prices.

Q. IS THE RIDER SRA-SRT AN AVOIDABLE CHARGE?

A. No. The purchases included in the Rider SRA-SRT are for the benefit of the entire system. All consumers benefit by the Company having adequate resources to meet all load that it is obligated to serve (*e.g.*, all retail load in its service

territory). Because it is for the benefit of all consumers, recovery of the costs should be from all consumers.

Q. ARE YOU INCLUDING ANY PROPOSED RATES FOR RIDER SRA-SRT AT THIS TIME?

A. No.

IV. PRICE-TO-COMPARE ANNUALLY ADJUSTED COMPONENT RIDER PTC-AAC

Q. WHAT IS THE ANNUALLY ADJUSTED COMPONENT?

A. The annually adjusted component, or Rider AAC, is a mechanism which allows the Company to recover certain costs for environmental compliance, incremental costs for Homeland Security, and allows the Company to pass through to consumers the costs or savings that result from changes in tax laws related to the production of electricity. Like Rider FPP and Rider SRT, this rider was effective for non-residential consumers beginning on January 1, 2005, and for residential consumers beginning January 1, 2006.

Q. WHAT TYPES OF COSTS ARE INCLUDED IN THE RIDER AAC REVENUE REQUIREMENT?

A. All of the costs included in the Rider AAC are incremental costs as compared to costs as of December 31, 2000, per the Stipulation approved in Case No. 03-93-EL-ATA, *et al.* The costs for environmental compliance included in the Rider AAC include a return of and on incremental investment in equipment, incremental operating and maintenance (O&M) expenses (including incremental projected environmental reagent costs), and incremental property taxes. Homeland security

costs include a return of and return on related investment, O&M expenses, and property taxes. Finally, Rider AAC includes changes in tax laws to the extent they impact the costs of production.

Q. HOW HAVE THE RIDER AAC MARKET PRICES BEEN SET IN THE PAST?

A. For 2005 and for 2006, the Rider AAC rates were set at rates agreed to as part of a settlement reached in Case No. 03-93-EL-ATA, *et al.* For non-residential consumers the 2005 Rider AAC was set at 4% of Little 'g'. For 2006, the non-residential Rider AAC was set at 8% of Little 'g'. For residential consumers, Rider AAC was zero for 2005 and 6% of Little 'g' for 2006.

Beginning in 2007, the Company developed the Rider AAC rate on a cost basis. However, due to the remand of the order in Case No. 03-93-EL-ATA, *et al.*, the proposed Rider AAC prices for 2007 were never fully implemented and the Rider AAC was left at the 2006 prices. The result was that the Company collected only a portion of its 2007 Rider AAC revenue requirement but, ultimately, the Commission approved full recovery of the 2007 Rider AAC revenue requirement. The Rider AAC rates were modified in such a way that the authorized recovery in 2008 included an amount to make the Company whole for its under-collection of Rider AAC revenue in 2007 due to the remand.

On September 4, 2007, DE-Ohio filed its application for the 2008 Rider AAC which was approved by the Commission on January 16, 2008. The Rider AAC prices that are in place today reflect the combined impact of the 2008 Rider

AAC revenue requirement and the true-up of the 2007 Rider AAC revenue requirement.

Q. WILL THERE BE ANY ADDITIONAL TRUE-UP OF THE CURRENT RIDER AAC?

A. Yes. Because the Rider AAC explicitly includes a provision to true-up the only component of the calculation based on projected data, environmental reagent costs, DE-Ohio will make a filing before April 1, 2009, to true-up the difference between actual and projected environmental reagent costs included in the Rider AAC for 2008.

Q. PLEASE DESCRIBE ANY DIFFERENCES BETWEEN DE-OHIO'S CURRENT RIDER AAC AND THE PROPOSED RIDER PTC-AAC DURING THE THREE-YEAR PERIOD OF THE ELECTRIC SECURITY PLAN?

A. The Company is proposing to maintain all elements of the current Rider AAC revenue requirement calculation in the proposed Rider PTC-AAC.. One significant difference, however, is that the Company is proposing to include another category of incremental costs. As discussed more fully in the testimony of Mr. Whitlock, DE-Ohio anticipates that it will make a substantial investment in equipment to increase its flexibility to burn different types of coal. The benefits of this flexibility is that the Company will first increase the diversity and, consequently, the reliability of its fuel supply by expanding its ability to burn more types of coal and, second, the Company expects to be able to lower its fuel costs that are passed on to consumers by potentially being able to utilize less

expensive supplies. Although other equipment may qualify, the Company is currently evaluating options to permit use of high-chlorine coal and equipment to minimize ash. Again, the ultimate objective is reliable supply and low cost, both of which benefit DE-Ohio's consumers.

Q. IS THE COMPANY PROPOSING TO UPDATE ITS CURRENT RIDER AAC AS PART OF THIS FILING?

A. Yes. Included in Part B, Schedule 3, of the ESP Application, is an updated Rider AAC which includes revised Rider AAC prices and the schedules supporting the Rider AAC revenue requirement.

Q. PLEASE PROVIDE A GENERAL OVERVIEW OF THE UPDATED RIDER AAC.

A. As discussed above, there are currently three major components of Rider AAC: environmental compliance costs, homeland security costs, and changes in tax rates due to changes in tax laws. All three of these components are incremental to the costs as of December 31, 2000.

Q. EXPLAIN HOW "INCREMENTAL ENVIRONMENTAL COSTS" ARE DETERMINED.

A. I followed the same methodology employed in each of the prior Rider AAC filings which have been audited by the Staff and approved by the Commission. As before, incremental environmental costs are determined by comparing contemporary costs for environmental compliance to the cost at some other point in time. In this case, May 31, 2008, investment and operating expenses for the

twelve months ended May 31, 2008, are compared to the same types of costs for the year 2000.

Q. DESCRIBE THE DEVELOPMENT OF INCREMENTAL ENVIRONMENTAL COSTS FOR THE UPDATED RIDER AAC REVENUE REQUIREMENT CALCULATION?

A. The calculation of the revenue requirement for environmental compliance is shown in detail on page 2, of Part B, Schedule 3,.

Q. WOULD YOU SUMMARIZE THE CALCULATION OF INCREMENTAL ENVIRONMENTAL COMPLIANCE COST?

A. The calculation begins with determining the incremental revenue requirement for environmental compliance. The revenue requirement represents the costs which are incremental to the year 2000 including (1) a return on the incremental environmental compliance net plant, including construction work in progress (CWIP) at May 31, 2008, using the pre-tax rate of return approved in the Company's most recent electric distribution rate case, Case No. 05-059-EL-AIR[2], (2) incremental annualized depreciation expense, and (3) incremental operation and maintenance (O&M) expenses for environmental equipment including reagent (*e.g.*, ammonia, lime, *etc.*) costs.

[2] The Company has a pending application for a rate increase, Case No. 08-709-EL-AIR, which will establish a new rate of return to use for the Rider AAC revenue calculation described herein.

Depreciation expense is annualized on the Plant-In-Service at May 31, 2008. O&M expenses are based on the actual twelve-month period ending May 31, 2008. Environmental reagent costs are projected for 2009.[3]

Q. ARE EMISSION ALLOWANCE COSTS INCLUDED IN RIDER AAC?

A. No. Because such costs vary with the level of generation, emission allowances are included in Rider FPP.

Q. DESCRIBE THE HOMELAND SECURITY COST COMPONENT OF RIDER AAC.

A. The Order in Case No. 03-93-EL-ATA, *et al.*, specifically allows the Company to include the incremental costs associated with Homeland Security in Rider AAC. In the current case, we have included costs based on the twelve-month period ending May 31, 2008. All "Homeland Security" costs are incremental compared to 2000. The methodology for incorporating Homeland Security costs is the same as has been used in the past Rider AAC annual filings.

Q. HOW WERE HOMELAND SECURITY COSTS INCLUDED?

A. Three types of projects were required for the Company to comply with Homeland Security regulation – physical security, cyber security, and Information Technology security. The Company incurred capital costs and O&M costs in each area to meet its compliance requirement. The pre-tax return from Case No. 05-059-EL-AIR was used to determine the return on the Net Plant as of May 31, 2008. To this return, annualized depreciation and property taxes were added, as

[3] Per the terms of a settlement reached in Case No. 05-806-EL-UNC, which was approved by the Commission, recovery of projected environmental reagent costs is included in the Rider AAC revenue requirement calculation.

well as the actual O&M for the twelve months ended May 31, 2008, to calculate the revenue requirement. As I mentioned earlier, all Homeland Security costs are incremental to the year 2000.

Q. DESCRIBE THE TAX COMPONENT OF RIDER AAC.

A. The intent of including "changes in taxes" as part of Rider AAC is to ensure that neither the Company nor consumers are harmed by changes in tax laws since the year 2000. Two tax law changes have impacted the Rider AAC calculation. The first item is the change to Internal Revenue Code (IRC), Section 199, which allows a permanent tax deduction for "Qualified Domestic Production." In as much as the generation of electricity is specifically identified as an eligible activity qualifying for this deduction, Rider AAC reflects the estimated net benefit to DE-Ohio's consumers as a result this tax law change.

In addition, certain legislative tax changes implemented by the State of Ohio have the effect of phasing out the Ohio Franchise Tax over a five-year period. At the same time, these taxes are being phased-out, the new Commercial Activity Tax is being phased-in. The incremental impact of these changes on the Company's retail generation operations for the twelve months ended May 31, 2008, is included in the Rider AAC calculation. These tax items decrease the amount requested by the Company in this proceeding.

Q. HOW HAVE YOU CALCULATED THE UPDATED RIDER AAC REVENUE REQUIREMENT?

A. Part B, Schedule 3, of the ESP Application provides all calculation used to update the Rider AAC revenue requirement. To summarize:

Page 1	*Summary of Rider AAC Revenue Requirement*
Page 2	*Revenue Requirement on Environmental Compliance*
Page 3	*Revenue Requirement on Homeland Security*
Page 4	*Tax Changes*

Q. HOW WAS THE BASE YEAR ENVIRONMENTAL COMPLIANCE REVENUE REQUIREMENT DETERMINED?

A. The base year is the calendar year 2000 with December 31, 2000, the "date certain" for plant. The methodology has been used and approved in prior Rider AAC filings and the base year financial information has been audited and approved in prior Rider AAC proceedings. As a reminder, the environmental compliance original cost and reserve for depreciation is from the Company's fixed asset records. The annualized depreciation was calculated on this plant balance. The O&M expenses and environmental reagent costs are the actual year 2000 expenses per the books and records of the Company.

Q. HOW WAS THE CURRENT YEAR ENVIRONMENTAL COMPLIANCE NET PLANT, SHOWN ON SCHEDULE 3 OF PART B, DETERMINED?

A. The current year environmental compliance net plant was calculated as of May 31, 2008, from the Company's fixed asset records. The CWIP balance as of that date was determined from the Company's construction tracking system.

Q. HOW WERE THE CURRENT YEAR ENVIRONMENTAL O&M EXPENSES DETERMINED?

A. These expenses are also from the Company's accounting records and are the actual expenses for the twelve months ended May 31, 2008.

Q. HOW WERE THE PROJECTED YEAR 2009 ENVIRONMENTAL REAGENT EXPENSES DETERMINED?

A. These expenses are the current budget estimates for the year 2009, as determined by the business managers at each of the Company operated generating stations. In addition, the Company's share of projected environmental reagent costs at jointly owned units operated by its partners was obtained from those companies.

Q. HOW DID YOU INCORPORATE THE TAX LAW CHANGES INTO THE RIDER AAC REVENUE REQUIREMENT CALCULATION SHOWN ON SCHEDULE 3, PART B?

A. The first tax law change included in the calculation is the Qualified Domestic Production deduction (IRC Section 199 deduction). This impact is based on the Company's stand-alone IRC Section 199 deduction for the tax year 2007. Duke Energy Ohio's 2007 Section 199 deduction is an estimate. The actual amount will be updated when the 2007 Federal Tax Return is complete. The effective Ohio Franchise Tax rate for the year 2008 was calculated recognizing that the tax is deductible in its own calculation. Then the effective federal income tax rate was determined after the reduction for the effective State tax rate. The combined effective federal and state tax rate was multiplied by the IRC Section 199 deduction amount to arrive at the tax benefit for the period.

The other relevant tax law change involves Ohio legislation which provides for the phase-out of the Ohio Franchise Tax over five years while phasing-in the Commercial Activity Tax. The Company's retail generation revenue and pre-tax income were used to determine the total tax under the prior

law and with the law in effect for the year 2008. The decrease in the total tax is included in the Rider AAC calculation.

Q. WHAT IS THE COMBINED REVENUE REQUIREMENT FOR RIDER AAC?

A. As shown on page 1 of Part B, Schedule 3, the total of the updated Rider AAC revenue requirement, including all of the components detailed above, is $141,276,736.

Q. IS THERE A TRUE-UP PROVISION FOR RIDER AAC?

A. The true-up provision for environmental reagents is a specific provision of the Stipulation approved in the Commission's Order in Case No. 05-806-EL-UNC allowing projected environmental reagent costs in Rider AAC. To the extent that actual costs for environmental reagents are higher or lower than projected, there will be a true-up provision in subsequent filings for this component of Rider AAC. The current Rider AAC includes a true-up of environmental reagent costs for 2007. The Company made a filing earlier this year to true-up the 2007 projected environmental reagent costs to the actual costs determined after the year was concluded. The impact was to reduce the overall 2008 Rider AAC revenue requirement by about $8 million as compared to the original filing.

Because all other components of Rider AAC are based on actual data, there is no true-up of other Rider AAC components.

Q. BASED ON THIS RIDER AAC REVENUE REQUIREMENT, IS THERE JUSTIFICATION TO CHANGE THE RIDER AAC PRICES?

A. Yes. The updated Rider AAC prices are higher than the current Rider AAC; so, a change in the Rider AAC market prices is warranted.

Q. HOW DID YOU DETERMINE THE RIDER AAC PRICES FROM THE REVENUE REQUIREMENT CALCULATED ABOVE?

A. The first step was to express the calculated updated revenue requirement for Rider AAC as a percent of little g revenue. To do this, I divided the total Rider AAC revenue requirement shown on page 1 of Part B, Schedule 3, by total little g revenue, on a non-switched basis (*i.e.*, as if no consumers switched), for the twelve month period ended May 31, 2008. The resulting Rider AAC price is calculated to be 17.3% of little g.

Q. YOU MENTIONED THAT, IN CALCULATING THE NEW RIDER AAC PRICE, YOU DIVIDE THE RIDER AAC REVENUE REQUIREMENT BY LITTLE G REVENUE ON A "NON-SWITCHED" BASIS. EXPLAIN WHAT YOU MEAN BY THAT.

A. Allocating the Rider AAC revenue requirement only to those consumers who did not switch has the potential to create a spiraling effect. Rider AAC is and will continue to be avoidable for all consumers. If the full amount of the Rider AAC revenue requirement is only recoverable by consumers who do not switch, then the Rider AAC prices for non-switching consumers become increasingly large which, in turn, creates even more incentive to switch to competitive suppliers as the Rider AAC is avoidable. The remedy is to impute little g revenue from switching consumers who avoid Rider AAC and add this number to the "per books" little g revenue for non-switched consumers.

The current method of calculating and imposing the Rider AAC prices puts the Company at some financial disadvantage as increasing levels of consumer switching diminish the Company's ability to fully recover its Rider AAC revenue requirement.

Q. HOW DID YOU ALLOCATE THE RIDER AAC REVENUE REQUIREMENT AMONG CONSUMER RATE CLASSES?

A. On pages 5 and 6 of Part B, Schedule 3, I provide an updated version of the Rider AAC tariff with the updated Rider AAC prices which shows how the new prices were calculated essentially from the ratio of the percentage of Rider AAC revenue requirement to the overall little g revenue collected and the imputed little g revenue from switching consumers through May 31, 2008. This calculated ratio is then simply applied to the little g rates identified on each tariff to determine the Rider AAC Market Price.

Q. DO YOU ANTICIPATE ANY CHANGES TO THESE PROPOSED UPDATED RIDER AAC PRICES?

A. Between now and the time these new Rider AAC prices become effective, DE-Ohio anticipates that the Commission Staff will audit the Company's Rider AAC update filing which could result in an adjustment depending on its findings. Further, some of the data used in this update filing is based on estimated data. To the extent that better estimated data or final actual data becomes between now and the effective date of the updated Rider AAC prices, the Company will update the filing with the new information and will update the proposed Rider AAC prices.

V. TRANSMISSION COST RECOVERY - RIDER TCR

Q. PLEASE SUMMARIZE THE COMPANY'S EXISTING RIDER TCR?

A. The Company makes semi-annual filings to recover all of its transmission costs which are regulated and approved by the Federal Energy Regulatory Commission (FERC). DE-Ohio's transmission-related costs can be broadly grouped into three categories: (1) network service revenue requirement, (2) ancillary services, and (3) charges from MISO. Rider TCR was implemented pursuant to the Stipulation approved in Case No. 03-93-EL-ATA, *et al.*, effectively to coincide with the beginning of the MISO Day 2 energy market, April 1, 2005. It was only then that the Company began experiencing 'incremental' costs related to transmission not already provided for in the Company's existing unbundled retail rates. Initially, Rider TCR was designed to recover *all* net charges billed to the Company from the MISO; however, as discussed earlier, the Company requested and received approval from the Commission to move certain net charges billed from MISO to the Rider FPP, namely, congestion and congestion-related charges (*e.g.*, FTRs) and marginal losses.

For the calculation of the network service revenue requirement, the Company relies on an annual filing made with the MISO and the FERC under Attachment O of the Open Access Transmission Tariff (OATT). This filing is made on behalf of all of Duke Energy Corp.'s Midwest operating companies, Duke Energy Indiana, Inc. (DE-Indiana), DE-Kentucky, and DE-Ohio and follows a prescriptive formula established by the FERC to determine the overall network service revenue requirement across the entire Duke Energy Midwest

footprint. DE-Ohio's revenue requirement is its load ratio share of the overall Duke Energy Midwest revenue requirement. All of the Rider TCR filings made to date have followed this method and rely on the then most recent version of the Attachment O filing.

The charges for ancillary services were established at the time of the unbundling case and have not changed since the inception of Rider TCR. As of September 9, 2008, three of the five ancillary services charged to retail consumers will be impacted by the MISO's introduction of its Day 3 Ancillary Services Market (ASM). At that time, Regulation and Frequency Response (Schedule 3), Spinning Reserve (Schedule 5), and Supplemental Reserve (Schedule 6) will be market-based. For Rider TCR, these three components will be adjusted such that the existing 'fixed' rate for these ancillary services will be eliminated. The actual costs incurred to provide these ancillary services to non-switching retail load will be billed to DE-Ohio by MISO and will be included in Rider TCR.

Finally, all of the other net charges billed by MISO, except for energy-related costs, congestion-related costs, and marginal losses will be included in the Rider TCR. It should be noted that the evolving nature of MISO has meant that there have been a number of new charges added and others eliminated since the beginning of the Day 2 market. Because MISO continues to evolve, it is expected that there will continue to be changes in the types of charges reflected on invoices from MISO.

Q. ARE THE RIDER TCR FILINGS AUDITED?

A. Yes. The Staff has audited each Rider TCR filing and has found no significant issues in any filing to date. The Staff also conducts a biennial review of the 'controllable' costs incurred by DE-Ohio. In its only report during the life of Rider TCR, to date, the Staff found that the Company was doing a reasonable job of controlling the costs for which it had any capacity to influence.[4]

Q. WHAT CHANGES DO YOU ANTICIPATE FOR THE RIDER TCR DURING THE PERIOD OF THE ESP?

A. The most significant change expected will be to comply with the filing requirements established in the Commission Staff's proposed rules under O.A.C. 4901-1-36, which establishes a template for filings to recover transmission costs. The Company's current Rider TCR filings contain virtually all of the information called for in the new rule; however, the format and order of exhibits will change in order to accommodate the new rules.

Although the proposed rule suggests that congestion costs be included in the Rider TCR, the Company continues to believe that the Rider PTC-FPP is more appropriate and its proposed riders reflect that position.

Another significant difference is the Staff's proposal to change to annual filings as opposed to the semi-annual filings made currently. The Company does not object to this change; however, it adds even more justification to moving the congestion costs to the Rider PTC-FPP which is updated more frequently, thus, mitigating the impact on the Company of this relatively volatile cost.

[4] See Commission Staff Biennial Report dated November 26, 2007.

Q. WILL THE COMPANY BE FILING ITS EXISTING RIDER TCR TO BE EFFECTIVE BEFORE THE ESP BEGINS?

A. No. The past practice has been to file for new Rider TCR rates every six months with effective dates on June 1 and December 1 of the year. These filings are made 45 days in advance of the effective date of the rates. Consequently, the next filing would be due on or before October 15, 2008, for rates effective December 1, 2008. However, the new rules governing the transmission cost recovery filings require that the now annual filings be made 75 days before the effective date of the rates. The impact of this rule is that the due date to establish rates effective January 1, 2009, under an ESP is the same as the due date for filing the Rider TCR under the existing practice.

The sensible solution is to let the existing Rider TCR rates persist through the end of the year, which is only one month longer than would normally be the case, and file for the 2009 Rider TCR rates on or before October 15, 2008. Any over- or under-recovery of 2008 Rider TCR revenue requirements will be trued-up in early 2009[5] as the proposed new rules provide for the ability to make changes throughout the year as necessary to avoid excessive positive or negative carrying costs.

Q. DO YOU HAVE ANY OTHER COMMENTS ABOUT THE PROPOSED RIDER TCR?

[5] Due to the nature of MISO billing, an initial true-up of 2008 will be done as early as the first quarter of 2009, but additional true-ups may be necessary as MISO issues restatements of the 2008 charges later in the year.

A. Yes. As I previously mentioned, MISO is still evolving. It may be necessary, from time to time, to adjust the components of Rider TCR to accommodate changes made by MISO. Our experience to date with MISO suggests that periodic adjustments are often necessary to ensure that the Company, shareholders, MISO, and other MISO stakeholders are made whole.

Q. ARE YOU FILING FOR APPROVAL OF RIDER TCR RATES FOR 2009 AT THIS TIME?

A. No. Following the guidelines in the proposed rules, O.A.C. 4901-1-36, we will file for new Rider TCR rates on or before October 15, 2008.

VI. DISTRIBUTION RIDER – INFRASTRUCTURE MODERNIZATION - RIDER DR

Q. PLEASE DESCRIBE THE RIDER DR-IM BEING PROPOSED BY THE COMPANY IN THIS PROCEEDING?

A. Rider DR-IM is a new rider the Company is proposing related to its distribution business. The objective of this rider is to recover, in a timely manner, investment and operating expenditures related to maintaining and modernizing an aging distribution system. As DE-Ohio's witness Mr. Tony R. Adcock discusses in his direct testimony, the expectation for the next few years is that the Company will make substantial investments in its distribution system.

Rider DR-IM is intended to balance the needs of the Company to maintain its financial stability and its commitment to shareholders, with the needs of its consumers to minimize costs and provide safe, reliable, and efficient service. Rider DR-IM is loosely modeled after the Company's Rider AMRP (Accelerated

Main Replacement Program) for gas service. The objective is timely recovery of a return of and on incremental investment in electric distribution plant and recovery of incremental electric distribution expenses net of any benefits and net of any revenue growth derived from growth in the number of distribution consumers served. The rider will be charged on a "per bill" basis to all consumers based on the cost of service study ultimately approved in the pending electric distribution rate case, Case No. 08-709-EL-AIR.

Q. WHAT TYPES OF COSTS WOULD BE INCLUDED IN RIDER DR-IM?

A. Rider DR-IM will be limited to only those plant and O&M accounts that are specifically distribution or distribution-related, including investments associated with the SmartGrid project and the Company's proposed Electronic Bulletin Board ("EBB") system, as discussed in the testimony of DE-Ohio witness Dr. Richard G. Stevie. All of the information will be auditable and much of the information will be readily available in the Company's Form 1 filed with the FERC and PUCO.

For incremental net plant, Rider DR-IM would be based on the year-end electric distribution plant original cost, net of accumulated depreciation, and will not include any construction work in progress (CWIP). Electric distribution plant original cost and accumulated depreciation is provided in the Form 1. Net plant will also include DE-Ohio's electric share of hardware and software development (collectively, information technology or IT) and communication equipment costs included in plant accounts other than electric distribution plant accounts. The adjustments to be included in the calculation of electric distribution rate base are

for accumulated deferred income taxes (ADITs) associated with electric distribution plant (Account 282), 3% and 4% Investment Tax Credit (ITC) on electric distribution plant, ADIT on uncollectible accounts, and the balance of Regulatory Assets – Meters as I will discuss later in this testimony. Although detailed information on ADITs and ITC is not publicly available, it is readily available from the Company and will be included in the proposed annual filings.

Incremental operation and maintenance expense would be limited to direct electric distribution expenses, FERC Accounts 580 through 598, and distribution-related A&G accounts, FERC Accounts 901 through 910. The eligible direct distribution O&M expenses include such costs as vegetation management and meter expenses. The distribution-related A&G accounts include such costs as call center and billing expenses.

Finally, we propose to include depreciation expense on electric distribution plant (also available in the Form 1), property taxes on electric distribution plant, and allocated IT costs. Property taxes are not reported in the Form 1 on a distribution-only basis but the information is estimable and will be included in the annual filings.

The return on the incremental electric distribution rate base will be the overall pre-tax weighted-average cost of capital established in Case No. 08-709-EL-AIR or the most recent approved rate of return at the time of the first Rider DR-IM filing. Unlike the Rider AMRP, however, we are not proposing to recover any post-in-service costs (*e.g.*, depreciation, carrying costs, *etc.*).

Part E, Schedule 2, of the ESP Application is an illustration of Rider DR-IM providing estimated calculations for years 2009 through 2011. The underlying in the Schedule data is based on the Company's forecast financial information for the distribution business as provided by the Company's Budgets and Forecasts Department.

Q. HOW DOES DE-OHIO PROPOSE TO ADJUST RIDER DR-IM?

A. DE-Ohio proposes to make an annual pre-filing on or before November 1 using nine months of actual data and three months of estimated data of Rider DR-IM costs/benefits for the current calendar year. DE-Ohio will update the filing by February 28 with an application and twelve months of actual data for Rider DR-IM costs/benefits. DE-Ohio will use its best efforts to resolve any stakeholder objections by April 1, and DE-Ohio requests that, if any Commission hearing is required to resolve stakeholder objections, that such hearing be held in early April, such that the new Rider DR-IM rates can be implemented with the May billing cycle.

In addition, DE-Ohio commits that it will file a status report on its deployment plan for its SmartGrid project with the Commission by August 1, annually, along with updates on any other significant distribution investments that DE-Ohio plans to make during the following calendar year. DE-Ohio will include in these status reports, the expected costs, a summary of expected consumer benefits for SmartGrid, and incremental rate impacts. Absent any Commission ruling to the contrary by October 1 each year, DE-Ohio requests that such expenditures be presumed to be prudent such that, if any stakeholder seeks to

assert in a subsequent Rider DR-IM proceeding or a subsequent general rate proceeding that such expenditures were imprudent, then that stakeholder shall bear the burden of proof the expenditures were imprudent and should be disallowed.

Q. ARE THERE ANY SPECIAL CIRCUMSTANCES RELATED TO THE SMARTGRID PROJECT THAT NEED TO BE ADDRESSED FOR DEVELOPING RATES?

A. Yes. There is an issue with the treatment of costs for the existing meters that will be replaced as part of the SmartGrid project and an issue with future technological advancements in metering technology.

Q. PLEASE EXPLAIN.

A. The cornerstone feature of the SmartGrid project is the replacement of existing meters that have limited technological capabilities with much more advanced "smart" meters. As discussed by DE-Ohio witness Todd W. Arnold, the Company is switching out existing meters with advanced meters and plans to have all of the meters completely switched out within the next few years. A significant issue is that the existing meters have book value remaining to be recovered after they have been replaced.

Generally accepted accounting principles require that these costs be removed from plant in-service and accumulated depreciation as retired. The Company is proposing to establish a regulatory asset to ensure full recovery of the investment in existing meters replaced as part of the SmartGrid in a manner which will have the least impact to consumers.

DE-Ohio also recognizes that, in modern times, technology-based equipment occasionally becomes obsolete within a short time frame – as seen with personal computers and cellular phones, for example. Consequently, if due to technological advancements, consumer needs, or DE-Ohio's business operations compel DE-Ohio to suspend or abandon all or part of its SmartGrid project, then DE-Ohio requests that it be permitted to recover such costs, even though the costs might not meet the Commission's traditional "used and useful" standard for cost recovery, as long as the costs were subject to Commission review and approval as part of DE-Ohio's annual deployment plan.

Q. HOW WILL THE REGULATORY ASSET BE DETERMINED?

A. Essentially, the regulatory asset will be debited for the net plant value of the meters retired in excess of the actual depreciation expense charged for the year on the existing meters per generally accepted accounting principles. Additionally, the balance of the regulatory asset will be amortized in an amount that, when added to the actual depreciation expense on the existing meters, equals the depreciation expense that would have been charged if there was no early retirement of the meters.

Q. WILL THIS REGULATORY ASSET AMORTIZATION BE REFLECTED IN RIDER DR?

A. Yes. The sum of the actual depreciation on existing meters and the amortization expense on the regulatory asset, described above, will essentially equal the dollar amount of depreciation expense proposed in this case for existing meters. The combined expense will continue at this fixed amount and will be included in

Rider DR-IM until the balance of the regulatory asset is $0. Similarly, the unamortized balance of the regulatory asset, combined with the net plant of the unretired meters and ADITs, will be included in the rate base component of Rider DR.

Q. HOW LONG WILL RIDER DR-IM BE IN EFFECT?

A. DE-Ohio proposes that Rider DR-IM be effective indefinitely. The rider will be updated each year beginning in late-2009, for rates effective in 2010, and every year thereafter except that whenever its retail distribution rates are established pursuant to an application for an increase in rates, the rider will be reset to $0 and the base for future filings will be reset to the updated base distribution revenue requirement.

VII. CONCLUSION

Q. WERE THE SCHEDULES YOU DISCUSSED HEREIN PREPARED BY YOU OR UNDER YOUR SUPERVISION?

A. Yes.

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

A. Yes.