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PUCO

October 24, 2008

**VIA FEDERAL EXPRESS**

Public Utilities Commission of Ohio  
Docketing Division  
180 East Broad Street  
Columbus, OH 43215-3793

**Re: Case No. 08-920-EL-SSO**

Dear Sir or Madam:

Enclosed for filing please find an original and 20 copies of the Direct Testimony of Michael P. Gorman on behalf of The Commercial Group in the above-referenced case.

Also enclosed are two extra copies of the document to be date-stamped and returned in the enclosed Federal Express envelope. Please do not hesitate to contact me at the number above if you have any questions.

Thank you for your assistance in this matter.

Sincerely,



Douglas M. Mancino

Grace C. Wung

DMM/maj  
Enclosures

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**BEFORE  
THE PUBLIC UTILITIES COMMISSION OF OHIO**

IN THE MATTER OF THE APPLICATION OF ) DUKE ENERGY OHIO, INC., FOR APPROVAL ) OF AN ELECTRIC SECURITY PLAN )	Case No. 08-920-EL-SSO
IN THE MATTER OF THE APPLICATION OF ) DUKE ENERGY OHIO, INC., FOR APPROVAL ) TO AMEND ACCOUNTING METHODS )	Case No. 08-921-EL-AAM
IN THE MATTER OF THE APPLICATION OF ) DUKE ENERGY OHIO, INC., 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, INC., FOR APPROVAL ) TO AMEND ITS TARIFF )	Case No. 08-923-EL-ATA

Direct Testimony of

**Michael Gorman**

On behalf of

**The Commercial Group**

October 27, 2008  
Project 9048



**BRUBAKER & ASSOCIATES, INC.**  
CHESTERFIELD, MO 63017

**BEFORE  
THE PUBLIC UTILITIES COMMISSION OF OHIO**

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IN THE MATTER OF THE APPLICATION OF DUKE ENERGY OHIO, INC., FOR APPROVAL TO AMEND ITS TARIFF	) ) )	Case No. 08-923-EL-ATA

**Direct Testimony of Michael Gorman**

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

2    **A     Michael Gorman. My business address is 16690 Swingley Ridge Road, Suite 140,**  
3       **Chesterfield, MO 63017.**

4    **Q     WHAT IS YOUR OCCUPATION?**

5    **A     I am a consultant in the field of public utility regulation and a managing principal with the**  
6       **firm of Brubaker & Associates, Inc., ("BAI") energy, economic, and regulatory**  
7       **consultants.**

8    **Q     PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.**

9    **A     These are set forth on Appendix A.**

1     **Q     ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?**

2     A     I am appearing on behalf of Wal-Mart Stores East, LP; Sam's East, Inc.; and Macy's Inc.  
3           (collectively, the "Commercial Group"). The Commercial Group purchases electricity  
4           from Duke Energy Ohio, Inc. ("Duke" or "Company").

5     **Q     WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?**

6     A     I will respond to certain aspects of Duke's Electric Security Plan ("ESP"), and related  
7           tariff rate mechanisms. Specifically, I will respond to the following:

- 8           1. The Company's proposed save-a-watt program should be rejected. As set forth  
9           below, the save-a-watt program is an impediment to the development of a least-cost  
10           integrated resource plan. Further, the save-a-watt program is also not designed to  
11           encourage maximum participation of customers in energy efficiency and demand  
12           response programs. The incentive for greater participation rests with the Company  
13           rather than customers to receive the economic benefits of these efficiency programs.  
14           Also, the save-a-watt program unjustifiably includes a revenue requirement for lost  
15           margin when the Company's projections do not show that a lost margin is necessary,  
16           or that other rate mechanisms do not already ensure that the Company fully recovers  
17           its cost of distribution utility service. For all these reasons, the save-a-watt concept  
18           should be rejected.
- 19          2. The Company's demand response and energy efficiency programs should include an  
20           opt-out provision for large commercial and industrial customers that undertake these  
21           types of programs on their own. This opt-out provision should allow these customers  
22           to avoid an energy efficiency and demand response program rider, and the Company  
23           should provide these customers access to wholesale demand response programs, or  
24           other programs offered by wholesale market participants that may help achieve the  
25           state's goal of energy efficiency and demand response management.
- 26          3. The Company's return on equity threshold used in its significantly excessive earnings  
27           test is based on a flawed analysis and is unreasonable. The Company's proposal for  
28           a 16.1% return on equity threshold as excessive earnings is unreasonably high.  
29           More reasonable methodologies supporting the current market cost of equity for a  
30           low risk regulated distribution utility, and using the Company's proposed spread over  
31           this market cost of equity would support a return on equity threshold of 12.5% for use  
32           in a significantly excessive earnings test.
- 33          4. The Company's proposed Rider PTC-FPP should be adjusted to reflect seasonal  
34           energy price periods and include a time-of-day option for primary and transmission  
35           delivery voltage customers.

**Rider DR – Save-A-Watt**

**Q PLEASE DESCRIBE THE COMPANY’S PROPOSED RIDER DR – SAVE-A-WATT.**

A The Company proposes to recover a revenue requirement for demand-side management and energy efficiency activities in Rider DR – Save-A-Watt (“SAW”). The Company proposes to recover a revenue requirement through this rider based on the following:

1. A percentage of the annual avoided capacity costs generated by demand response programs,
2. A percentage of the net present value of avoided energy and capacity costs produced by conservation programs, and
3. The lost distribution margins caused by these energy efficiency programs.

For each of the avoided cost estimates, the Company will apply a sharing percentage of the estimated avoided cost to create the revenue requirement subject to be recovered through this rider. The Company proposes a reconciliation feature to create additional charges or credits based on the difference between the amounts billed for projected avoided cost savings, and lost margins, and the amount of avoided cost and lost margins found appropriate by an independent party. The Company is also proposing a cap on earnings related to these energy efficiency programs.

The Company proposes that the charges and programs for Rider DR – SAW will be created separately for residential and non-residential customers. (Duke witness Paul G. Smith, Attachment PGS-5).

**Q DOES DUKE’S PROPOSED RIDER DR – SAW REPRESENT AN APPROPRIATE DEMAND RESPONSE AND ENERGY EFFICIENCY POLICY?**

A No. The proposed SAW program is not a reasonable policy, and is also not consistent with the Ohio law’s Electric Security Plan’s (“ESP”) objective of competitive utility rates.

**Q PLEASE EXPLAIN WHY THE SAVE-A-WATT ("SAW") PROGRAM IS NOT CONSISTENT WITH MAINTAINING COMPETITIVE UTILITY RATES.**

**A** The SAW program is inappropriate regulatory policy for the following reasons:

1. The SAW program does not use demand-side management and energy conservation programs as a component of integrated resource planning to minimize the cost of the ESP to Ohio native load customers.
2. The SAW program will charge customers more for demand-side management and conservation program costs than the utility actually incurs. This will result in excessive and unreasonable prices to retail customers.
3. The SAW program will potentially allow the utility to earn excessive returns on investment in the provision of regulated utility services. Again, this would indicate that the rates charged to Ohio native load customers would not be just and reasonable.
4. The proposal to include lost distribution margins as recoverable in this rider will result in an unjustified increase in utility rates.
5. The Company's proposed earnings cap will not provide an economic incentive for the Company to manage its program costs for energy efficiency and demand-side resource programs. The Company is proposing to develop an earnings cap based on a return on program costs as an incentive for increasing participation in energy efficiency and demand-side programs. Hence, since the earnings cap is tied to program costs, the Company's earnings cap will increase as the program cost increases. As such, this earnings cap methodology is not designed to encourage the Company to reasonably manage its program costs. Therefore, again, the SAW program is not consistent with maintaining least-cost utility service.

**Q WHY IS THE SAW PROGRAM NOT CONSISTENT WITH DEVELOPING AN INTEGRATED RESOURCE PLAN ("IRP") THAT WILL ENSURE UTILITY CUSTOMERS RECEIVE THE LEAST-COST UTILITY SERVICE?**

**A** Under Duke's proposal, the proposed SAW concept fails to integrate energy conservation and demand-side management programs into an IRP in an effort to minimize the total cost of service from all resources. In other words, a least cost resource plan would integrate the reasonable cost of energy conservation, demand response and supply-side resources, in an IRP that will result in a lowest cost utility service.

1    **Q     WHY DOESN'T THE SAW PROPOSAL MEET THIS LEAST COST IRP STANDARD?**

2    A     Under Duke's proposal, demand response ("DR") programs and conservation programs  
3       ("CP") will not be considered as an alternative to supply-side options. Rather, DR/CP  
4       will be priced at the avoided cost of the supply-side alternative. The expectation is that  
5       the avoided power cost will be more expensive than the cost of the DR and CP. Duke's  
6       SAW plan will deprive Ohio customers of the lower cost benefits of DR programs and CP  
7       which can be implemented in lieu of higher cost supply-side resource alternatives. As  
8       such, Duke's proposal would not result in the least cost IRP available to meet native load  
9       customers' demands in Ohio.

10   **Q     WHY DO YOU BELIEVE THE SAVE-A-WATT PROGRAM IS NOT DESIGNED TO**  
11       **ENCOURAGE CUSTOMERS TO PARTICIPATE IN ENERGY EFFICIENCY**  
12       **PROGRAMS?**

13   A     The economic benefit of energy efficiency programs is to avoid high cost energy  
14       purchases through the installation of energy efficiency programs. Under the Company's  
15       proposed save-a-watt plan, the Company will retain a significant portion of the avoided  
16       energy cost savings. As such, the economic benefits to customers of participating in  
17       energy efficiency programs are significantly eroded. In a more appropriately designed  
18       plan, the Company should benefit through full cost recovery of reasonable and prudent  
19       energy efficiency programs, and a fair rate of return made on these programs. The  
20       customers for these programs, then should receive the full benefit of avoided energy  
21       costs while fully compensating the Company for the cost of the programs. As such, the  
22       save-a-watt program is designed to allocate most of the economic benefits of energy  
23       efficiency programs to the Company, and leaves significant uncertainty as to whether or  
24       not the economic benefits to customers will be justified or adequate to provide

customers the incentive to fully participate. Therefore, this program is unjust and should be rejected.

**Q PLEASE EXPLAIN WHY THE SAW PROGRAM WILL REQUIRE CUSTOMERS TO PAY RATES BASED ON COSTS WHICH ARE NOT KNOWN AND MEASURABLE.**

A The avoided cost for demand response and energy conservation programs, that would be subject to recovery through Rider DR – SAW, will be based on economic assumptions or studies that project avoided demand and energy usage based on projected customer participation. The SAW assumption is simply based on the premise that as more customers participate in certain DR and CP activities, demand and energy consumption will decline. However, the SAW program fails to recognize that customers may increase consumption for other purposes, despite reduced energy conservation consumption for programs. In the end, total consumption may not decline, and no power costs would actually be avoided.

As a result, there is no actual confirmation that customers will use less energy and power cost will be avoided. Therefore, the SAW revenue requirement is not known and measurable.

**Q WHY IS IT INAPPROPRIATE TO ALLOW THE COMPANY TO RECOVER LOST MARGINS IN RIDER DSM?**

A The Company's conservation programs and demand-side response programs may reduce sales relative to previous periods which may reduce the amount of distribution revenue collected by the Company. However, that does not necessarily mean the Company will not fully recover its cost of distribution service. The Company's overall sales are a dynamic process. The Company sales will most likely increase over time from increasing customers and change consumption unrelated to conservation efforts.



1 As such, reduced distribution sales caused by conservation programs may be offset in  
2 whole or in part by increasing sales caused by other factors.

3 **Q IF LOST MARGINS WERE CREATED DUE TO REDUCED SALES, ARE THERE**  
4 **REGULATORY MECHANISMS THAT CAN PROTECT THE COMPANY AGAINST**  
5 **THESE PROFIT LOSSES?**

6 **A** Yes. Frequent adjustments to distribution rates can ensure the Company's distribution  
7 revenues fully compensate the Company for its cost of distribution service. Indeed, in  
8 this proceeding, the Company is proposing Rider DR-IM. This rider will adjust for the  
9 incremental cost of distribution plant investment, along with load growth revenue  
10 requirement changes. As such, the Company is proposing regulatory mechanisms that  
11 can adjust its prices for distribution service in order to ensure it fully recovers its  
12 distribution cost of service on an annual basis. With this rider, the Company's proposal  
13 for lost margins is egregious and unreasonable and should be rejected.

14 **Q WHAT WOULD HAPPEN IF DUKE COLLECTED LOST MARGIN FROM ENERGY**  
15 **EFFICIENCY MEASURES BUT OVERALL SALES DID NOT DECLINE?**

16 **A** Duke's retail rates would not be just and reasonable and it could earn an excessive  
17 profit. For example, if sales declines caused by conservation programs are offset  
18 completely by increasing sales caused by normal sales growth, then the revenue  
19 produced for distribution services may provide full recovery of distribution utility services,  
20 and provide fair compensation to the utility. In this instance, if the utility is allowed to  
21 recover lost margins caused by conservation programs, which will produce additional  
22 revenue for its distribution services, then it would over-recover its distribution utility  
23 service costs. That increased distribution revenue from lost margin collection, in turn,

1 will result in it collecting more than fair compensation from customers, and in total its  
2 charges to customers would then not be just and reasonable.

3 **Q PLEASE DESCRIBE THE COMPANY'S PROPOSED CAP ON EARNINGS RELATED**  
4 **TO ITS ENERGY EFFICIENCY PROGRAMS.**

5 **A** The Company proposed to establish a return on investment threshold based on the ratio  
6 of achieved energy efficiency savings, relative to the initial projection of energy efficiency  
7 savings. The Company argues that if this ratio meets certain thresholds, then its return  
8 on investment ("ROI") should move accordingly. Specifically, the Company argues that  
9 if its ratio is greater than 105%, the Company would be allowed to earn up to 18% ROI.  
10 If the ratio is between 105% and 80%, the Company can earn up to a 15% ROI, and if  
11 the ratio is below 80% the Company can earn an ROI of 9%.

12 This ROI percentage is then applied to the total three-year cost of energy  
13 efficiency programs, which include all incentives, administrative cost, measurement and  
14 verification ("M&V") expenses, marketing and advertising, capital costs, and other  
15 program-related expenses. The three-year earnings cap will be the product of the ROI  
16 percentage times the total three-year program costs. If the net income from energy  
17 efficiency programs is equal to or less than the earnings cap, then no credits or  
18 adjustments are made. However, if the Company's actual program net income exceeds  
19 the earnings cap, then credits are made to customers. These credits would be adjusted  
20 upward by an income tax factor to convert the excess earnings to a revenue  
21 requirement.

**1 Q IS THE COMPANY'S PROPOSED EARNINGS CAP ON ENERGY EFFICIENCY**  
**2 PROGRAMS REASONABLE?**

**3 A** No. This earnings cap is specifically designed to allow the Company to over-recover its  
**4** actual cost of energy efficiency programs. Further, this earnings cap methodology does  
**5** not create an economic incentive to manage the program costs.

**6 Q WHY IS THE CAP ON EARNINGS DESIGNED TO ALLOW DUKE TO OVER-**  
**7 RECOVER ITS PROGRAM COSTS?**

**8 A** If the Company achieves the threshold that allows it to earn an 18% ROI, then  
**9** customers would be asked to pay 129% of the program cost under this earnings test.  
**10** Specifically, an 18% ROI, increased by a composite income tax factor of 1.6x, implies a  
**11** revenue requirement of program cost of 129%. At the low end of this scale, an ROI of  
**12** 15% implies revenue requirement at 114% of program costs (9% times a factor of 1.6).  
**13** The Company's earnings cap is flawed because it is designed to simply allow the  
**14** Company to over-recover its actual cost of energy efficiency program expenses.

**15 Q PLEASE EXPLAIN WHY THE EARNINGS CAP WILL NOT CREATE AN INCENTIVE**  
**16 FOR THE COMPANY TO MANAGE ITS PROGRAM COSTS.**

**17 A** Because the earnings cap is tied to an ROI multiplied by program costs, the earnings  
**18** cap will increase as the program costs increase. This could cause the Company to  
**19** accept a program vendor that does not offer the lowest cost program in an effort to  
**20** increase the earnings cap. Hence, the earnings cap may create incentives at odds with  
**21** managing costs.

**Significantly Excessive Earnings Test**

**Q PLEASE DESCRIBE DUKE'S PROPOSED SIGNIFICANTLY EXCESSIVE EARNINGS TEST.**

**A** Duke witness Judah Rose proposes a significantly excessive earnings test return on equity ("ROE") threshold of 16.1% for the test required under 4928.143(E), and a 21.2% ROE for the test required under 4928.143(F). (Direct Testimony at 9).

**Q HOW DID MR. ROSE DERIVE THIS SIGNIFICANTLY EXCESSIVE EARNINGS TEST RETURN ON EQUITY THRESHOLD?**

**A** Duke witness Mr. Rose estimates that the significantly excessive earnings test should encompass a return on equity ("ROE") band in the range of 11.8% to 16.1%. This range is based on a CAPM return study of highly regulated electric utilities and deregulated companies (Direct Testimony at 54-55). He applied a weight of 70% to the deregulated companies' CAPM return estimate of 14.8% (midpoint), and a 30% weight to a highly regulated utility CAPM return estimate of 12.5% (midpoint). This weighted average return was 14.1% with a range of 11.8% to 16.1%. He concluded that excessive earnings would be in excess of the 16.1% return on equity threshold (*id.* at 54-55).

**Q DO YOU HAVE ANY COMMENTS RELATED TO MR. ROSE'S PROPOSED THRESHOLD FOR A SIGNIFICANTLY EXCESSIVE EARNINGS TEST?**

**A** Yes. Mr. Rose's estimated significantly excessive earnings test ROE threshold is overstated and unreasonable for the following reasons:

1. His proposal to provide a 70% weight to the return on equity for unregulated merchant generation companies is unjust and unreasonable.
2. His estimated return on equity for highly regulated utilities of 12.5% as shown on his Exhibit 19 at page 55 of his testimony is significantly overstated and flawed. Clear market evidence shows that a fair risk adjusted return for regulated electric utility

1 operations is no higher than 10.5%, and this return has ensured strong credit and  
2 access to both debt and equity capital.

3 **Q WHY WOULD IT BE INAPPROPRIATE TO INCLUDE THE PROJECTED MARKET**  
4 **COST OF COMMON EQUITY FOR A DEREGULATED COMPANY IN DUKE OHIO'S**  
5 **EXCESSIVE EARNINGS TEST THRESHOLD AS PROPOSED BY MR. ROSE?**

6 **A** The Ohio law specifically states that the significantly excessive return on equity test  
7 should be based on the distribution utility's earnings, and that the return on equity should  
8 reflect an earnings threshold that has comparable business and financial risk to the  
9 electric distribution utility.

10 Mr. Rose failed to recognize that electric distribution utilities are generally  
11 regarded as very low risk enterprises, which are not comparable in business risk to  
12 companies involved in merchant generation development and operation, and commodity  
13 trading operations.

14 **Q DO YOU HAVE EVIDENCE FROM MARKET PARTICIPANTS THAT CONFIRMS**  
15 **YOUR BELIEF THAT THE MARKET PERCEIVES DISTRIBUTION UTILITY**  
16 **COMPANIES TO HAVE LOWER BUSINESS RISK THAN MERCHANT GENERATION**  
17 **COMPANIES?**

18 **A** Yes. Standard & Poor's ("S&P") assessed the operating or business risk of utility  
19 companies and merchant generation companies in a report entitled "New Business  
20 Profile Scores Assigned for U.S. Utility and Power Companies; Financial Guidelines  
21 Revised," June 2, 2004.

22 In that report, S&P assigned ratings for the business risk of utility companies and  
23 merchant power producers on a scale of '1' (lowest risk) to '10' (highest risk). In that  
24 report, S&P found that transmission and distribution electric utility companies had

1 business profile scores generally in the range of '1' to '4.' This generally indicates that  
2 transmission and distribution electric utility companies had relatively low operating risk  
3 businesses. In comparison, integrated electric utility companies had business profile  
4 scores in the range of '4' to '6.' Further, energy merchant generators and power trading  
5 companies had business profile scores in the range of '8' to '10.'

6 This assessment by S&P clearly refutes Mr. Rose's contention that Duke's  
7 distribution utility operations in Ohio have comparable business risk to a merchant  
8 generation company.

9 **Q IS IT COMMON FOR DISTRIBUTION UTILITIES TO PROCURE POWER UNDER**  
10 **COMPETITIVE SOLICITATION CONTRACTS, AND RESELL IT TO END-USE**  
11 **CUSTOMERS IN A MANNER SIMILAR TO WHAT DUKE ENERGY OHIO WILL DO?**

12 **A** Yes. Indeed, the rate structures that allow for the cost recovery of purchased power cost  
13 largely impact the operating risk of a distribution utility company. However, a purchased  
14 power cost recovery mechanism with annual true-ups and automatic rate adjustment  
15 mechanisms, will significantly lower the power cost recovery risk of the distribution utility  
16 company, and improve its business risk rating. Duke's proposed Rider PTC-FPP will be  
17 adjusted annually with a reconciliation factor (William Don Wathen Jr. Direct at 8-9).  
18 Hence, Duke will not have significant purchased power cost recovery risk.

19 **Q HOW DID MR. ROSE DEVELOP HIS CAPM RETURN ESTIMATES FOR**  
20 **DEREGULATED AND HIGHLY REGULATED ENTERPRISES?**

21 **A** Mr. Rose's CAPM return estimate for non-regulated and regulated enterprises is based  
22 on an unlevered beta of 0.79, a re-levered beta of 1.22, a market risk premium of 7.1%,  
23 a risk-free rate of 4.88% (Direct at 46 and 52), and a combined size and fuel mix

1 adjustment of about 0.56%. Using these parameters, he derived a CAPM return of  
2 14.1%.

3 **Q DO YOU BELIEVE THAT MR. ROSE'S CAPM RETURN ESTIMATES ARE**  
4 **REASONABLE?**

5 **A** No. A more reasonable CAPM return estimate would be based on a traditional CAPM  
6 return estimate using *Value Line's* published beta estimates for regulated utility  
7 companies. Mr. Rose's proposal to de-lever and then re-lever the beta suggests that  
8 utilities' financial risk can be measured by only changes in common equity weights of  
9 capital structure, and that financial risk is the only relevant systematic risk reflected in  
10 beta. Neither of these factors are accurate. First, a utility company's financial risk is a  
11 component of capital structure mix, but also can be impacted by its embedded cost of  
12 debt, debt maturity and other liquidity factors. For example, a utility that has lower cost  
13 debt and a higher debt percentage of total capital, may have lower financial risk than a  
14 utility with a lower debt ratio if its cash flow coverages of interest and total debt are  
15 stronger than the latter company. Mr. Rose's analysis is not based on a complete  
16 assessment of financial risk.

17 Also, financial risk is not the only systematic risk that should be considered in  
18 adjusting beta. Systematic risk can include many factors that were not properly  
19 considered by Mr. Rose.

20 **Q DO YOU HAVE ANY OTHER ISSUES WITH MR. ROSE'S CAPM STUDIES?**

21 **A** Yes. Mr. Rose only considered the highest estimate of a market risk premium published  
22 by Morningstar. As set forth below, Morningstar estimates market risk premiums in the  
23 range of 6.2% to 7.1%. Using the midpoint of Morningstar's market risk premium range,

1 or 6.65%, would be more reasonable than Mr. Rose's proposed use of only the high end  
2 of the Morningstar market risk premium estimate.

3 **Q PLEASE DESCRIBE MORNINGSTAR'S MARKET RISK PREMIUM STUDIES.**

4 **A** Morningstar estimates a forward-looking market risk premium based on actual achieved  
5 data from the historical period of 1926 through year-end 2007. Using this data,  
6 Morningstar estimates a market risk premium derived from the total return on large  
7 company stocks (S&P 500), less the income return on Treasury bonds. The total return  
8 includes capital appreciation, dividend or coupon reinvestment returns, and annual  
9 yields received from coupons and/or dividend payments. The income return, in contrast,  
10 only reflects the income return received from dividend payments or coupon yields.  
11 Morningstar argues that the income return is the only true riskless rate associated with  
12 the Treasury bond and is the best approximation of a truly risk-free rate. While I  
13 disagree with this assessment from Morningstar, because it does not reflect a true  
14 investment option available to the marketplace, and therefore does not produce a  
15 legitimate estimate of the expected premium of investing in the stock market versus that  
16 of Treasury bonds, I will use Morningstar's conclusion to show the reasonableness of my  
17 market risk premium estimates.

18 Morningstar's analysis indicates that a market risk premium falls somewhere in  
19 the range of 6.2% to 7.1%. This range is based on several methodologies. First,  
20 Morningstar estimates a market risk premium of 7.1% based on the difference between  
21 the total market return on common stocks (S&P 500) less the income return on Treasury  
22 bond investments. Second, Morningstar found that if the New York Stock Exchange (the  
23 "NYSE") was used as the market index rather than the S&P 500, that the market risk  
24 premium would be 6.8% and not 7.1%. Third, if only the two deciles of the largest



1 companies included in the NYSE were considered, the market risk premium would be  
2 6.35%.<sup>1</sup>

3 Finally, Morningstar found that the 7.1% market risk premium based on the S&P  
4 500 was impacted by an abnormal expansion of price-to-earnings ("P/E") ratios relative  
5 to earnings and dividend growth during the period 1980 through 2001. Morningstar  
6 believes this abnormal P/E expansion is not sustainable. Therefore, Morningstar  
7 adjusted this market risk premium estimate to normalize the growth in the P/E ratio to be  
8 more in line with the growth in dividends and earnings. Based on this alternative  
9 methodology, Morningstar published a long-horizon supply-side market risk premium of  
10 6.2%.<sup>2</sup>

11 **Q PLEASE DESCRIBE THE CAPM RETURN ADDERS PROPOSED BY MR. ROSE.**

12 **A** Mr. Rose proposed to increase his non-regulated company CAPM return estimate of  
13 14.3%, up to 14.8% for two adjustments. First, he proposed an upward adjustment for a  
14 small company liquidity premium of 0.81%. Second, he proposed a return on equity  
15 reduction of 0.33% for higher base load share for Duke Ohio compared to his  
16 comparable companies. He argues that base load assets have less risk. The  
17 combination of these two adjustments increased his CAPM return estimate by  
18 approximately 0.5%. Similarly, Mr. Rose includes an upward adjustment to his regulated  
19 return on equity of 11.70%, which results in his CAPM return on equity estimate for the  
20 regulated companies of 12.5%.<sup>3</sup>

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<sup>1</sup> Morningstar observes that the S&P 500 and the NYSE Decile 1-2 are both large capitalization benchmarks. *Ibbotson SBI 2008 Valuation Yearbook* (Morningstar, Inc.) at 72 and 74.

<sup>2</sup> *Id.* at 92-98.

<sup>3</sup>  $4.88\% + 0.96(7.1) = 11.70\% + 0.81\% = 12.5\%$

**Q ARE MR. ROSE'S CAPM RETURN ADD-ONS REASONABLE?**

A No. First, in identifying a liquidity adjustment based on Duke Ohio's small company size, he neglected to recognize that Duke Ohio is part of a larger holding company, Duke Energy Corp. Duke Ohio receives management, engineering, accounting, financial and treasury services from its parent company. Indeed, all external common equity for Duke Ohio is derived from its parent company. As such, Mr. Rose has inaccurately assessed the small size risk of Duke Ohio because he has failed to recognize it as a subsidiary of a much larger company. As such, the CAPM return on equity adder is not justified.

**Q USING A CAPM, WHAT RETURN ON EQUITY WOULD BE REASONABLE FOR A REGULATED ELECTRIC UTILITY COMPANY?**

A As developed on Exhibit MPG-1, the electric industry beta published by *The Value Line Investment Survey* of 0.83, a market risk premium of 6.65%, and a current projected Treasury bond yield of 4.9%,<sup>4</sup> produces a CAPM return estimate of 10.42%.

**Q WHY DO YOU BELIEVE THAT THE CURRENT MARKET COST OF EQUITY FOR REGULATED UTILITY COMPANIES IS NO HIGHER THAN 10.5%?**

A I believe this is a very conservative estimate of the market cost of equity for regulated utility operations as clearly supported by evidence. Specifically, as shown in the table below, since 2005, the average commission-authorized return on equity for regulated utility companies has been 10.34%.

---

<sup>4</sup> *Blue Chip Financial Forecast*, October 1, 2008 at 2.

**TABLE 1**

**Industry Average Authorized  
Returns on Equity for Electric Utilities**

<b><u>Year</u></b>	<b><u>Return on Equity</u></b>
2005	10.52%
2006	10.30%
2007	10.26%
2008	10.28%
Average	10.34%

---

Source: Edison Electric Institute: Rate Case Summary,  
Financial Update Q2, 2008.

1           These authorized returns on equity for regulated utility companies are widely  
2 known to the marketplace and are considered by credit and equity investors in part in  
3 determining the credit rating of utility companies, and helping to inform investment  
4 valuation decisions. With this understanding, these authorized returns on equity have  
5 supported investment grade credit rating, and robust stock price performance for electric  
6 utility companies over the last five years.

7           This credit quality and stock performance clearly indicate that the commission-  
8 authorized returns on equity for utility companies have met investors' return  
9 expectations, have been compensatory, and have supported financial integrity. All of  
10 this indicates that a regulated return on equity no higher than 10.5% is a reasonable and  
11 accurate excessive earnings benchmark.

1    **Q     PLEASE DESCRIBE THE MARKET EVIDENCE THAT THE INDUSTRY AUTHORIZED**  
2           **RETURN ON EQUITY DURING THIS TIME PERIOD HAS SUPPORTED UTILITIES'**  
3           **FINANCIAL INTEGRITY AND ACCESS TO CAPITAL.**

4    **A     The Edison Electric Institute ("EEI"), an electric utility industry trade organization,**  
5           **provided an assessment of the credit rating history of U.S. electric utilities over the**  
6           **period 2002 through the first quarter 2008. EEI's commentary included the following:**

7           **COMMENTARY**

8           Industry credit quality showed a modest decline during Q1 2008, as  
9           13 downgrades outnumbered five upgrades. The quarter's total activity  
10          was relatively quiet, however, and nearly half of the 13 downgrades  
11          resulted from ConEd's recent rate case decision. The industry's general  
12          credit quality has actually improved steadily over the last three years, with  
13          upgrades outnumbering downgrades in ten of the prior 12 quarters and in  
14          each of the last three calendar years. The Q1 downgrades were driven  
15          mostly by rate case developments, with cash flow concerns and rising  
16          debt for capital expenditure (capex) programs also cited. The upgrades  
17          resulted from companies focusing on core utility businesses and  
18          achieving a related improvement in their financial profiles. Ratings  
19          outlooks were mostly negative at quarter-end for the second straight  
20          quarter, as they were for most of 2007.<sup>5</sup>

21          Further, Standard & Poor's ("S&P") also acknowledges the improving credit  
22          standing of the electric utility industry in its report. S&P states:

23          **Key Credit Trends**

24          The U.S. utility industry demonstrated stable credit quality in the fourth  
25          quarter of 2006, and should continue to do so in 2007 despite increasing  
26          capital spending needs related to reliability enhancements and  
27          environmental requirements. A general refocus by the industry in recent  
28          years on restoring balance sheet health and selling noncore business  
29          operations has enhanced its ability to withstand the pressure that  
30          substantial capital spending will bring.

31          A credit element during this coming growth phase, however, will be fair  
32          and equitable treatment by state regulators as utilities seek to recover the  
33          capital expenditures they will incur to address declining reserve margins,  
34          aging and increasingly fragile infrastructure, and environmental  
35          mandates. Standard & Poor's Ratings Services expects that most utilities  
36          will seek pre-approval from regulators of any substantial spending  
37          program, or at least a broad understanding of the principles that  
38          regulators will apply in granting recovery. Of comparable significance to

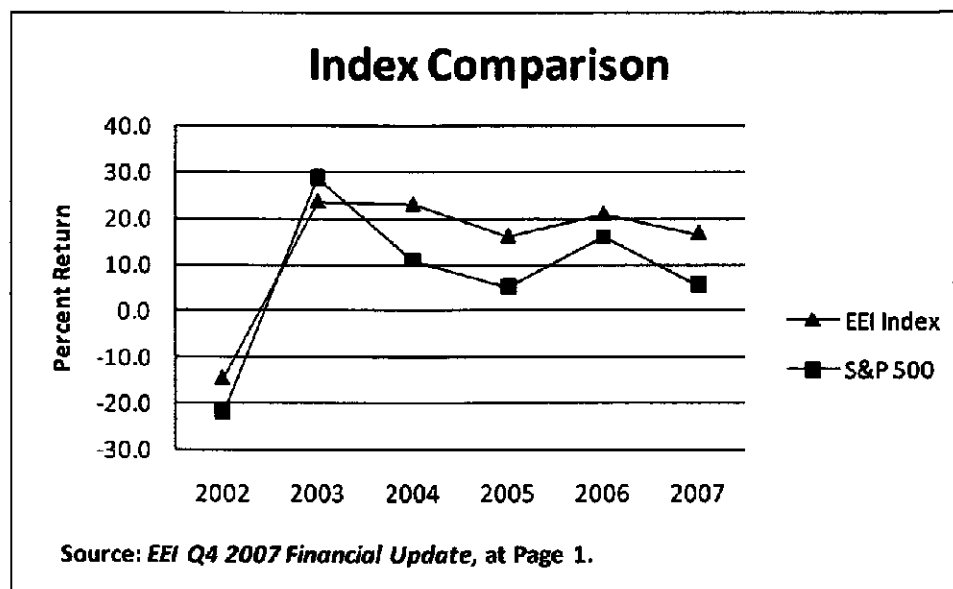
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<sup>5</sup> "Q1 2008 Credit Ratings," EEI Q1 2008 *Financial Update*, emphasis added.

supporting credit quality is regulatory approval for timely recovery of fuel costs, especially in an environment of elevated commodity prices.<sup>6</sup>

**Q PLEASE DESCRIBE THE EVIDENCE THAT ELECTRIC UTILITY STOCK PRICE PERFORMANCE HAS BEEN STRONG OVER THE LAST 5 YEARS.**

**A** Yes. As shown in the graph below, EEI has recorded electric utility stock price performance compared to the market. The EEI data shows that its Electric Utility Stock Index has outperformed the market in every year over the last 6 years. Again, this strong stock performance indicates commission-authorized returns on equity over the last several years have been positively received by the market.



This robust electric utility stock price performance is additional evidence that the regulatory orders over the last five years have supported regulated utilities' financial integrity and access to capital.

<sup>6</sup> "Despite Demands For Increased Capital Spending, U.S. Utility Ratings Should Remain Stable," Standard & Poor's *RatingsDirect*, January 12, 2007, at 1.

1    **Q     IF 10.5% IS USED AS THE CURRENT MARKET COST OF EQUITY FOR HIGHLY**  
2       **REGULATED UTILITY COMPANIES, WHAT RANGE WOULD MR. ROSE'S**  
3       **METHODOLOGY PRODUCE FOR A RETURN ON EQUITY EXCESSIVE EARNINGS**  
4       **TEST THRESHOLD?**

5    **A     In his Table 19, Mr. Rose estimated the difference between the high end at the 95%**  
6       **confidence level and low end, of approximately 2.0 percentage points around the**  
7       **estimate of the market cost of equity. Specifically, he estimated a highly regulated**  
8       **electric utility market cost of equity of 14.1%, and a range for return on equity for use in**  
9       **establishing an excessive earnings test threshold between 11.8% and 16.1%. Adjusting**  
10      **this range for a more reasonable midpoint estimate of 10.5%, would indicate an**  
11      **appropriate return on equity range of 8.5% to 12.5%.**

12    **Proposed Rider PTC-FPP**

13    **Q     IS THE COMPANY PROPOSING TO MODIFY ITS RIDER PTC-FPP?**

14    **A     Yes. As discussed by Duke witness William Don Wathen, Jr., at page 3-10 of his direct**  
15       **testimony, Mr. Wathen is proposing to modify this rider to allow Duke to recover all fuel**  
16       **and purchased power expense, environmental cost, and losses in this rider.**

17    **Q     DO YOU PROPOSE ANY ADJUSTMENTS TO THE COMPANY'S PROPOSED**  
18       **MODIFIED RIDER PTC-FPP?**

19    **A     I do not take issue with the Company's proposed cost recovery, but I do recommend that**  
20       **this rider be adjusted to include a fuel and purchased power energy pricing**  
21       **differentiation for seasonal use for primary voltage and transmission level customers. I**  
22       **also recommend that this rate include a time-of-day rate option for transmission level**  
23       **and primary use customers.**

1    **Q     WHY WOULD IT BE APPROPRIATE TO INCLUDE SEASONAL ENERGY RATE**  
2       **DIFFERENTIALS AND A TIME-OF-DAY OPTION?**

3    **A     An objective of the new Ohio law is to encourage customers to wisely consume electric**  
4       **power and to pursue energy efficiency and demand-side management programs. In**  
5       **order to ensure customers maximize the economic alternatives available for reducing**  
6       **energy consumption and demand consumption, customers will need an accurate price**  
7       **signal of the cost of energy avoided. Therefore, a seasonal differentiation in energy**  
8       **price, and time-of-day option pricing will provide customers with direct and accurate**  
9       **pricing signals of their real-time cost of power. By avoiding the purchase of power in**  
10      **high cost periods, there can be greater avoided cost savings, which can allow large**  
11      **commercial and industrial customers to justify making more investments in energy**  
12      **efficiency devices. Large commercial and industrial customers often look at the**  
13      **economic justification for making energy efficiency investments. If the large customers**  
14      **receive the full avoided cost of reducing energy during high cost periods, the savings**  
15      **from energy efficiency activities will be greater, which in turn can justify making larger**  
16      **investments in energy efficiency programs. As a result, it is in line with the energy**  
17      **efficiency and demand response objectives to maximize the potential savings to**  
18      **customers for making investments in these programs in order to maximize the reduction**  
19      **and efficiency of energy procurement.**

20   **Q     DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

21   **A     Yes.**

**Qualifications of Michael Gorman**

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

2    **A     Michael Gorman. My business mailing address is 16690 Swingley Ridge Road, Suite**  
3       **140, Chesterfield, MO 63017.**

4    **Q     PLEASE STATE YOUR OCCUPATION.**

5    **A     I am a consultant in the field of public utility regulation and a managing principal with**  
6       **Brubaker & Associates, Inc., energy, economic and regulatory consultants.**

7    **Q     PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND WORK**  
8       **EXPERIENCE.**

9    **A     In 1983 I received a Bachelor of Science Degree in Electrical Engineering from**  
10       **Southern Illinois University, and in 1986, I received a Master's Degree in Business**  
11       **Administration with a concentration in Finance from the University of Illinois at**  
12       **Springfield. I have also completed several graduate level economics courses.**

13           **In August of 1983, I accepted an analyst position with the Illinois Commerce**  
14       **Commission ("ICC"). In this position, I performed a variety of analyses for both formal**  
15       **and informal investigations before the ICC, including: marginal cost of energy, central**  
16       **dispatch, avoided cost of energy, annual system production costs, and working**  
17       **capital. In October of 1986, I was promoted to the position of Senior Analyst. In this**  
18       **position, I assumed the additional responsibilities of technical leader on projects, and**  
19       **my areas of responsibility were expanded to include utility financial modeling and**  
20       **financial analyses.**

21           **In 1987, I was promoted to Director of the Financial Analysis Department. In**  
22       **this position, I was responsible for all financial analyses conducted by the staff.**



1 Among other things, I conducted analyses and sponsored testimony before the ICC  
2 on rate of return, financial integrity, financial modeling and related issues. I also  
3 supervised the development of all Staff analyses and testimony on these same  
4 issues. In addition, I supervised the Staff's review and recommendations to the  
5 Commission concerning utility plans to issue debt and equity securities.

6 In August of 1989, I accepted a position with Merrill-Lynch as a financial  
7 consultant. After receiving all required securities licenses, I worked with individual  
8 investors and small businesses in evaluating and selecting investments suitable to  
9 their requirements.

10 In September of 1990, I accepted a position with Drazen-Brubaker &  
11 Associates, Inc. In April 1995 the firm of Brubaker & Associates, Inc. ("BAI") was  
12 formed. It includes most of the former DBA principals and Staff. Since 1990, I have  
13 performed various analyses and sponsored testimony on cost of capital, cost/benefits  
14 of utility mergers and acquisitions, utility reorganizations, level of operating expenses  
15 and rate base, cost of service studies, and analyses relating industrial jobs and  
16 economic development. I also participated in a study used to revise the financial  
17 policy for the municipal utility in Kansas City, Kansas.

18 At BAI, I also have extensive experience working with large energy users to  
19 distribute and critically evaluate responses to requests for proposals ("RFPs") for  
20 electric, steam, and gas energy supply from competitive energy suppliers. These  
21 analyses include the evaluation of gas supply and delivery charges, cogeneration  
22 and/or combined cycle unit feasibility studies, and the evaluation of third-party  
23 asset/supply management agreements. I have also analyzed commodity pricing  
24 indices and forward pricing methods for third party supply agreements, and have also  
25 conducted regional electric market price forecasts.

1 In addition to our main office in St. Louis, the firm also has branch offices in  
2 Phoenix, Arizona and Corpus Christi, Texas.

3 **Q HAVE YOU EVER TESTIFIED BEFORE A REGULATORY BODY?**

4 A Yes. I have sponsored testimony on cost of capital, revenue requirements, cost of  
5 service and other issues before the Federal Energy Regulatory Commission and  
6 numerous state regulatory commissions including: Arkansas, Arizona, California,  
7 Colorado, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas,  
8 Louisiana, Michigan, Missouri, Montana, New Jersey, New Mexico, New York, North  
9 Carolina, Oklahoma, Oregon, South Carolina, Tennessee, Texas, Utah, Vermont,  
10 Virginia, Washington, West Virginia, Wisconsin, Wyoming, and before the provincial  
11 regulatory boards in Alberta and Nova Scotia, Canada. I have also sponsored  
12 testimony before the Board of Public Utilities in Kansas City, Kansas; presented rate  
13 setting position reports to the regulatory board of the municipal utility in Austin, Texas,  
14 and Salt River Project, Arizona, on behalf of industrial customers; and negotiated rate  
15 disputes for industrial customers of the Municipal Electric Authority of Georgia in the  
16 LaGrange, Georgia district.

17 **Q PLEASE DESCRIBE ANY PROFESSIONAL REGISTRATIONS OR ORGANI-**  
18 **ZATIONS TO WHICH YOU BELONG.**

19 A I earned the designation of Chartered Financial Analyst ("CFA") from the CFA  
20 Institute. The CFA charter was awarded after successfully completing three  
21 examinations which covered the subject areas of financial accounting, economics,  
22 fixed income and equity valuation and professional and ethical conduct. I am a  
23 member of the CFA Institute's Financial Analyst Society.

## Duke Energy Ohio

### Electric Utility Industry Group

<u>Line</u>	<u>Utility</u>	<u>Beta</u>
1	Allegheny Energy	1.10
2	ALLETE	0.85
3	Alliant Energy	0.80
4	Amer. Elec. Power	0.85
5	Ameren Corp.	0.80
6	Avista Corp.	0.85
7	Black Hills	0.85
8	Cen. Vermont Pub. Serv.	1.05
9	CenterPoint Energy	0.90
10	CH Energy Group	0.90
11	Cleco Corp.	0.90
12	CMS Energy Corp.	0.95
13	Consol. Edison	0.75
14	Constellation Energy	0.85
15	Dominion Resources	0.75
16	DPL Inc.	0.75
17	DTE Energy	0.75
18	Duke Energy	N/A
19	Edison Int'l	0.85
20	El Paso Electric	0.95
21	Empire Dist. Elec.	0.80
22	Entergy Corp.	0.80
23	Exelon Corp.	0.85
24	FirstEnergy Corp.	0.75
25	FPL Group	0.80
26	G1 Plains Energy	0.75
27	Hawaiian Elec.	0.75
28	IDACORP Inc.	0.85
29	Integrus Energy	0.80
30	MDU Resources	0.85
31	MGE Energy	0.85
32	NiSource Inc.	0.80
33	Northeast Utilities	0.75
34	NSTAR	0.80
35	OGE Energy	0.85
36	Otter Tail Corp.	0.85
37	Pepco Holdings	0.80
38	PG&E Corp.	0.85
39	Pinnacle West Capital	0.75
40	PNM Resources	0.90
41	Portland General	N/A
42	PPL Corp.	0.85
43	Progress Energy	0.75
44	Public Serv. Enterprise	0.85
45	Puget Energy Inc.	0.80
46	SCANA Corp.	0.80
47	Sempra Energy	0.90
48	Sierra Pacific Res.	0.95
49	Southern Co.	0.65
50	TECO Energy	0.85
51	UIL Holdings	0.80
52	UniSource Energy	0.70
53	Vectren Corp.	0.80
54	Westar Energy	0.85
55	Wisconsin Energy	0.75
56	Xcel Energy Inc.	0.75
57	<b>Average</b>	<b>0.83</b>

Source:

*Value Line Investment Analyzer*, downloaded  
on October 10, 2008

Before the  
The Public Utilities Commission of Ohio

IN THE MATTER OF THE APPLICATION OF DUKE ENERGY OHIO, INC., FOR APPROVAL OF AN ELECTRIC SECURITY PLAN	) ) )	Case No. 08-920-EL-SSO
IN THE MATTER OF THE APPLICATION OF DUKE ENERGY OHIO, INC., FOR APPROVAL TO AMEND ACCOUNTING METHODS	) ) )	Case No. 08-921-EL-AAM
IN THE MATTER OF THE APPLICATION OF DUKE ENERGY OHIO, INC., 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, INC., FOR APPROVAL TO AMEND ITS TARIFF	) ) )	Case No. 08-923-EL-ATA

**Affidavit of Michael Gorman**

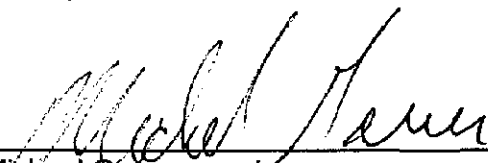
State of Missouri     )  
                              )  
County of St. Louis   )     SS

Michael Gorman, being first duly sworn, on his oath states:

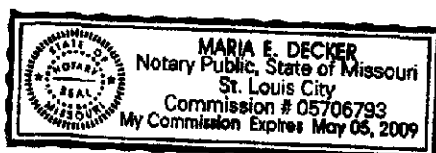
1. My name is Michael Gorman. I am a consultant and managing principal with Brubaker & Associates, Inc., having its principal place of business at 16690 Swingley Ridge Road, Suite 140, Chesterfield, Missouri 63017. We have been retained by The Commercial Group, Inc. in this proceeding on its behalf.

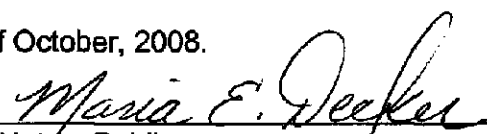
2. Attached hereto and made a part hereof for all purposes are my direct testimony and exhibit which were prepared in written form for introduction into evidence in the Public Utilities Commission of Ohio Case Nos. 08-920-EL-SSO, 08-921-EL-AAM, 08-922-EL-UNC and 08-923-EL-ATA.

3. I hereby swear and affirm that the testimony and exhibit are true and correct and show the matters and things they purport to show.

  
\_\_\_\_\_  
Michael Gorman

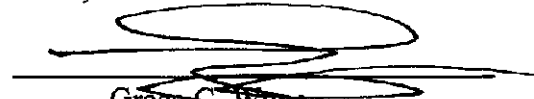
Subscribed and sworn to before me this 22nd day of October, 2008.



  
\_\_\_\_\_  
Notary Public

**CERTIFICATE OF SERVICE**

I hereby certify that I caused a copy of the "Direct Testimony of Michael P. Gorman on behalf of The Commercial Group" to be served either via first class mail or electronic mail upon the following parties of record on the 27th day of October, 2008.



Grace C. Wing

CERTIFICATE OF SERVICE LIST: DUKE ENERGY OHIO 08-920

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<p>M. Howard Petricoff, Esq.  Steven M. Howard, Esq.  Counsel for Integrlys Energy Services, Inc.,  Direct Energy Services LLC, Constellation  NewEnergy, Inc. and Constellation Energy  Commodities Group, Inc., Ohio  Association School Business Officials,  Ohio School Board Association, Buckeye  Association of School Administrators,  University of Cincinnati  Vorys, Sater, Seymour and Pease LLP  52 East Gay Street  P.O. Box 1008  Columbus, OH 43216-1008  <a href="mailto:mhpetricoff@vorys.com">mhpetricoff@vorys.com</a></p>	<p>Craig G. Goodman, Esq.  National Energy Marketers Association  3333 K Street, N.W., Suite 110  Washington, DC 20007  <a href="mailto:cgoodman@energymarketers.com">cgoodman@energymarketers.com</a></p>
<p>Sally W. Bloomfield  Terrence O'Donnell  American Wind Energy Association,  Wind on the Wires,  Ohio Advanced Energy  100 South Third Street  Columbus, OH 43215-4236  <a href="mailto:sbloomfield@bricker.com">sbloomfield@bricker.com</a>  <a href="mailto:todonnell@bricker.com">todonnell@bricker.com</a></p>	<p>Larry Gearhardt  Ohio Farm Bureau Federation  280 N. High Street  P.O. Box 182383  Columbus, OH 43218-2383  <a href="mailto:LGearhardt@ofbf.org">LGearhardt@ofbf.org</a></p>

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