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BEFORE

THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Investigation into the Development of the Significantly Excessive Earnings Test Pursuant to S.B. 221 for Electric Utilities.	))))	Case No. 09-786-EL-UNC

INITIAL COMMENTS
OF
DUKE ENERGY OHIO, INC.

The Public Utilities Commission of Ohio (Commission) is required, under certain circumstances, to determine whether an electric utility's rates result in the utility garnering significantly excessive earnings, as set forth in various provisions of Amended Substitute Senate Bill No. 221. Specifically, division (D) of Section 4928.142, Revised Code, requires consideration of whether certain adjustments to a market rate offer would cause an electric distribution utility to earn a return on common equity that is significantly in excess of the return on common equity that is earned by publicly traded companies, including utilities, that face comparable business and financial risk, with such adjustments for capital structure as may be appropriate. Similarly, in the context of an electric security plan that lasts for more than three years, the Commission is required to determine, every four years, whether the prospective effect of the plan is substantially likely to provide the electric distribution utility with a return on common equity that is significantly in excess of the return on common equity that is likely to be earned by publicly traded companies, including utilities, that face comparable business and financial risk, with such adjustments for capital structure as may be appropriate (Section

4928.143(E), Revised Code). Finally, the Commission must, at the end of each annual period of an electric security plan that includes adjustments that might impact earnings, consider if any adjustments resulted in excessive earnings, as measured by whether the earned return on common equity of the electric distribution utility is significantly in excess of the return on common equity that was earned during the same period by publicly traded companies, including utilities, that face comparable business and financial risk, with such adjustments for capital structure as may be appropriate (Section 4928.143(F), Revised Code).

On September 23, 2009, in its development of a significantly excessive earnings test (SEET) to be used in these circumstances, the Commission determined that a workshop should be held to discuss several identified issues. Following the workshop, on November 18, 2009, Staff of the Public Utilities Commission of Ohio (Staff) issued its recommendations for the Commission's consideration in this proceeding. On November 19, 2009, the attorney examiner ordered that comments and reply comments relating to the Staff recommendations may be filed by December 14, 2009, and January 4, 2010, respectively.

The following are the initial comments of Duke Energy Ohio, Inc. (Duke Energy Ohio). The numbered items correlate directly with the issues that were addressed in the Staff recommendations.

2. Should the Commission determine SEET on a single-entity basis or a company-wide basis?

Commission Staff has recommended that the SEET be, in all cases, calculated for an individual entity. Staff, in making that recommendation, points out that rate schedules are unique to each utility and that each individual utility would be responsible for making restitution to customers if its rates were deemed excessive. Finally, Staff quotes language from division (F) of Section 4928.143, Revised Code, in which the legislature required that, in making a determination concerning significantly excessive earnings under that division, the Commission is not to consider the revenue, expenses, or earnings of any affiliate or parent of the utility. Duke Energy Ohio has several concerns regarding this conclusion and rationale.

First, and most importantly, in reaching this conclusion, Staff does not take into account the differences in accounting issues between a situation in which the utility wholly owns a subsidiary utility and one in which two utilities are both owned by a parent holding company. Duke Energy Kentucky, Inc., (Duke Energy Kentucky) is a Kentucky electric and gas utility that is a wholly owned subsidiary of Duke Energy Ohio. Therefore, according to standard accounting practices, the financial books and records of Duke Energy Ohio reflect information that relates to its own utility business, consolidated with that of its subsidiary. Many individual costs are allocated between the two companies, making a separation for purposes of the SEET difficult, as would seem to be indicated by Staff's recommendation. It is noteworthy that the Form 1 required by the Federal Energy Regulatory Commission (FERC) requires a balance sheet that reflects the investment of Duke Energy Ohio in its subsidiaries, one of which is Duke Energy Kentucky[1], and that the Form 10-K filed with the Securities and Exchange Commission includes the debt of Duke Energy Kentucky.

Although there may be justification for omitting affiliates and holding company parents from the calculation of the SEET for a utility, a different treatment should apply to wholly owned subsidiaries. If such a subsidiary is excluded, then all aspects of the financial records will

[1] Other Duke Energy Ohio subsidiaries include Miami Power Corporation, KO Transmission Company, Tri-State Improvement Company, Cinergy Power Investments, Inc., and Sugartree Timber, LLC. Duke Energy Ohio also has a 9% ownership interest in Ohio Valley Electric Corporation.

have to be separated. Critically for this test, the capitalization of Duke Energy Ohio would have to be allocated between itself and its subsidiaries. That allocation process could easily lead to protracted disputes.

The circumstances for Duke Energy Ohio are further complicated by the fact that the Company owns and operates a gas distribution system in addition to its electric facilities. Although not a separate, affiliated company, it could be argued that balance sheet and income statement items be allocated between its gas and electric businesses. The Company does not necessarily advocate segregating the businesses but notes that it could give rise to additional controversy among parties that may participate in any proceeding regarding the SEET.

Part of the rationale for Staff's conclusion also appears to be the language in the last sentences of division (F) of Section 4928.143, Revised Code. As quoted by Staff, the Commission is not to consider revenue, expenses, or earnings of any affiliate or parent company. Of course, that language does not address wholly owned subsidiaries or the impact of operating a combined electric and gas system. The legislature, in enacting this statute, could have chosen to explicitly require the exclusion of subsidiaries' revenue, expenses, or earnings, but did not do so. It is not up to the Commission to alter the legislature's intent.

Staff's recommendation on this issue should be limited to those circumstances in which it is the financial impact of a holding company parent or an affiliate that would be excluded from consideration. It should not be interpreted to require allocation of balance sheet and income statement items relating to separate electric and natural gas operations and should not apply to wholly owned subsidiaries. If Staff's recommendation in this regard is adopted by the Commission, an additional process may be necessitated for the reasonable resolution of the accounting issues that would arise with regard to the allocation of capitalization between a utility and its wholly owned subsidiaries.

3. What adjustments should be included in the SEET calculation? and 11. How should write-offs and deferrals be reflected in the return on equity calculation for SEET?

Staff makes specific recommendations, under this item, with regard to potential adjustments to be made in the calculations under the SEET. The following comments on this topic relate to the impact of these recommendations only on Duke Energy Ohio.

Duke Energy Ohio is in a unique situation. The Stipulation that was signed and adopted by the Commission in the proceeding for its electric security plan included specific agreement as to the adjustments that would be made in the implementation of the significantly excessive earnings test. *In the Matter of the Application of Duke Energy Ohio for Approval of an Electric Security Plan*, Case No. 08-920-EL-SSO (Stipulation, October 27, 2008; Opinion and Order, December 17, 2008). Paragraph 28 of the Stipulation states that the return on common equity is to be computed using the Duke Energy Ohio FERC Form 1 financial statements from the prior year, including off-system sales, subject to certain listed adjustments. The Stipulation does not say that adjustment would be made to remove items associated with non-Ohio service areas. As the Commission has already approved this test for Duke Energy Ohio, the Company strenuously rejects the notion that such a change should be made, for Duke Energy Ohio, in this proceeding of broad application.

5. What is the definition of "significantly in excess of the return on common equity"?

According to Staff's recommendation, the Commission would find a return on common equity of the greater of 200 basis points above the mean or in excess of 1.28 (expressed as basis points) times the standard deviation above the mean of a comparable group of companies to be significantly in excess of the return on common equity. Duke Energy Ohio disagrees with Staff's proposed definition. In *In the Matter of the Application of Duke Energy Ohio for Approval of an Electric Security Plan*, Case No. 08-920-EL-SSO, the Company presented the testimony of Mr. Judah M. Rose, which recommended using a 95% confidence level or 1.64 standard deviations above the mean. Mr. Rose advocated using a comparable group that is weighted by traditionally regulated utilities and fully non-regulated industries. Duke Energy Ohio believes this is the threshold that defines the level of earnings that is "*significantly* excessive." The legislature included the adjective "significantly" in order to avoid capturing situations in which earnings are just somewhat higher than average. Without a threshold at the 95% confidence level level, it is difficult to conclude that earnings are *significantly* excessive.

Also, the Staff's recommendation, which it attributes to First Energy's witness Dr. Michael J. Vilbert,[2] disregards a significant qualification made by Dr. Vilbert that his recommended confidence level would increase from 1.28 standard deviations if a comparable group of companies from industries other than the electric utility industry is used for purposes of calculating the SEET.

8. What does "in the aggregate" mean in relation to the adjustments resulting in significantly excess earnings?

In response to this issue, Staff recommends that the term "in the aggregate," in relation to the adjustments resulting in significantly excess earnings, means that the total of all of the adjustments created in the process of implementing an ESP should be assessed. Duke Energy

[2] See Direct Testimony of Dr. Michael J. Vilbert, Case No. 08-935-EL-SSO, filed July 31, 2008.

Ohio does not understand Staff's recommendation as clarifying the statutory language. Without any further clarification of Staff's position, Duke Energy Ohio cannot determine whether to express any comment on this recommendation. In light of the lack of clarity in this statement, Duke Energy Ohio reserves the right to develop and advocate a position on this issue at a subsequent point in time.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I certify that a copy of the foregoing was served on the following parties, this 14th day of December 2009, via regular mail delivery, postage prepaid.

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