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DUKE ENERGY OHIO EXHIBIT______

BEFORE

THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application of Duke Energy Ohio, Inc., for an Increase in Electric Distribution Rates.	)))	Case No. 12-1682-EL-AIR
In the Matter of the Application of Duke Energy Ohio, Inc., for Tariff Approval.	)))	Case No. 12-1683-EL-ATA
In the Matter of the Application of Duke Energy Ohio, Inc., for Approval to Change Accounting Methods.	)))	Case No. 12-1684-EL-AAM

DIRECT TESTIMONY OF

WILLIAM DON WATHEN JR.

ON BEHALF OF

DUKE ENERGY OHIO, INC.

______	Management policies, practices, and organization
______	Operating income
______	Rate Base
______	Allocations
______	Rate of return
X	Rates and tariffs
X	Other: Rate Case Drivers

July 20, 2012

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I. INTRODUCTION AND PURPOSE

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is William Don Wathen Jr., and 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 Business Services LLC (DEBS) as Director of Rates and Regulatory Strategy for Ohio and Kentucky. DEBS provides various administrative and other services to Duke Energy Ohio, Inc., (Duke Energy Ohio or Company) and other affiliated companies of Duke Energy Corporation (Duke Energy).

Q. PLEASE BRIEFLY SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND PROFESSIONAL EXPERIENCE.

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 the position of Director - Rates. On December 1, 2009, I took the position of General Manager and Vice President of Rates, Ohio and Kentucky.

On July 3, 2012, as a result of the merger between Duke Energy and Progress Energy Corp., my title changed to Director of Rates and Regulatory Strategy for Ohio and Kentucky.

Q. PLEASE SUMMARIZE YOUR RESPONSIBILITIES AS DIRECTOR OF RATES AND REGULATORY STRATEGY FOR OHIO AND KENTUCKY.

A. As Director of Rates and Regulatory Strategy for Ohio and Kentucky, I am responsible for all state and federal rate matters involving Duke Energy Ohio and Duke Energy Kentucky, Inc.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE PUBLIC UTILITIES COMMISSION OF OHIO?

A. Yes. I previously testified in a number of cases before the Public Utilities Commission of Ohio (Commission) and other regulatory commissions.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THESE PROCEEDINGS?

A. On behalf of Duke Energy Ohio, I am submitting this testimony to support the reasonableness of the Company's request to increase its base electric distribution revenues; its requests for certain tariff modifications; and its requests for certain accounting authority related to the overall request. I discuss the background of Duke Energy Ohio's requested rate increase and the drivers for Duke Energy Ohio's current revenue deficiency.

II. BACKGROUND AND DRIVERS FOR REQUESTED RATE INCREASE

Q. WHEN DID THE COMMISSION APPROVE DUKE ENERGY OHIO'S CURRENT ELECTRIC DISTRIBUTION RATES?

A. Duke Energy Ohio's current electric distribution rates were approved by this Commission pursuant to an Order dated July 8, 2009, in Case No. 08-709-EL-AIR, *et al.* The test period in that proceeding was the twelve months ended December 31, 2008, and the date certain was March 31, 2008. The rates went into effect on or about July 13, 2009.

Q. WHY DOES DUKE ENERGY OHIO BELIEVE A DISTRIBUTION RATE INCREASE IS NECESSARY AT THIS TIME?

A. Since March 31, 2008, the date certain used in the prior rate case, Duke Energy Ohio has invested approximately $450 million in capital additions and improvements to provide safe and reliable electric distribution service. Duke Energy Ohio's current rates are not sufficient to recover the costs associated with the investments made. In addition, distribution-related operation and maintenance (O&M) expenses have increased. For example, as explained in the Direct Testimony of Richard D. Harrell, the Company has implemented a number of programs (*e.g.*, the ground-line inspection program) since the previous rate case to increase reliability. The increased investment and operating costs prevent Duke Energy Ohio from earning a reasonable return on its distribution business, absent an increase in its current rates.

Duke Energy Ohio electric distribution operations are projected to earn a 3.18 percent return on its rate base during the twelve-month test period ended

December 31, 2012. Although the most recent electric distribution case was approved without specifying a return, the return for the test year in the current case is well below the 9.10 percent return on rate base requested by the Company in that case and is also well below the Staff's recommended range of 8.34 percent to 8.87 percent.[1] More importantly, the 3.18 percent projected return on rate base is substantially below the 8.13 percent return on rate base being proposed in these proceedings. In order to earn a fair return of 8.13 percent, Duke Energy Ohio's electric distribution rates must be increased to generate approximately $86.6 million in incremental annual revenue to satisfy a total base electric distribution revenue requirement of approximately $447 million, exclusive of all riders.

Q. HOW DOES THE COMPANY'S ONGOING GRID MODERNIZATION PROGRAM IMPACT THE INCREASE BEING REQUESTED IN THESE PROCEEDINGS?

A. It has no direct impact. Of the $450 million in capital expenditures made since March 31, 2008, approximately $138 million has been for grid modernization-related projects. As part of a settlement in Case No. 10-2326-GE-RDR (approved by the Commission on June 13, 2012), the Company will continue recovering implementation costs for the grid modernization via a separate rider, namely, Rider DR-IM. Another condition of the approved settlement is that the Company will file for new base rates around 2015 to incorporate the grid modernization investment into base rates after full deployment of the grid modernization program. Consequently, the revenue requirement being proposed in this electric

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[1] *In the Matter of the Application of Duke Energy Ohio, Inc., for an Increase in Electric Distribution Rates*, Case No. 08-709-EL-AIR, *et al.*, Opinion and Order (July 8, 2009) and Staff Report (January 27, 2009).

distribution rate case excludes any recovery directly related to grid modernization. Duke Energy Ohio witness Peggy A. Laub addresses the adjustments required to accommodate the conditions of the June 13, 2012, order in the grid modernization case.

Q. WHAT ARE THE PRIMARY DRIVERS FOR THIS EARNINGS ATTRITION?

A. The primary drivers of the proposed $86.6 million rate increase include:

- $17.6 million is attributable to return on incremental plant investment;
- $14.9 million is attributable to lower retail sales and reduced customer count;
- $22.4 million is attributable to increased operating costs;
- $18.8 million is attributable to higher property and other non-income related taxes; and
- $18.1 million is attributable to increased depreciation and amortization expense.

Factors offsetting these rate increase drivers include:

- $2.0 million is attributable to lower debt financing costs; and
- $3.2 million higher miscellaneous revenue.

The balance of the increase is from miscellaneous other factors.

Q. WHAT RATE RELIEF IS DUKE ENERGY OHIO REQUESTING IN THESE PROCEEDINGS?

A. In its July 9, 2012, application, Duke Energy Ohio specifically requested that the Commission issue an Order:

- To increase base rates by $86.6 million;

- To establish a deferral mechanism to track storm costs against a base amount; and

- To establish a Facilities Relocation - Mass Transportation Tariff (Rider FRT).

III. DUKE ENERGY OHIO'S PROCESS AND METHODOLOGY FOR PREPARATION OF ITS RATE CASE

Q. WHAT IS THE OVERALL GOAL OF THE RATEMAKING PROCESS?

A. The overall goal of the ratemaking process is to give the regulated utility the opportunity to recover all of its prudently incurred operating expenses and to earn a fair return on its capital invested in the business. The Ohio Revised Code succinctly recognizes traditional ratemaking. In particular, R.C. 4905.22 states that all charges for service shall be just and reasonable and not more than allowed by law or by order of the Commission. That is precisely the objective of the normal ratemaking process and such a goal is to be achieved by charging rates that fairly assign the cost of service to the various customer classes.

Q. HOW DOES DUKE ENERGY OHIO PREPARE AN ELECTRIC DISTRIBUTION RATE CASE?

A. The lengthy and often complicated electric distribution rate case preparation process essentially consists of three primary steps: (1) determine the annual electric distribution revenue requirement; (2) develop a cost of service study that assigns and allocates the electric distribution revenue requirement to each retail rate schedule based on the applicable cost to serve; and (3) design the retail rates and rate schedules to yield the necessary retail revenue requirement.

Q. PLEASE GIVE AN OVERVIEW OF THE REVENUE REQUIREMENT DETERMINATION PROCESS EMPLOYED BY DUKE ENERGY OHIO.

A. Duke Energy Ohio's revenue requirement process focuses on determining: (1) the current level of capital invested in the electric distribution business; (2) the appropriate capital structure and cost of capital to finance the investment; and (3) the ongoing level of annual expenses related to operating and maintaining the electric distribution business. Duke Energy Ohio witness Laub supports the determination of Duke Energy Ohio's jurisdictional revenue requirement.

Q. PLEASE GIVE AN OVERVIEW OF THE RETAIL COST OF SERVICE STUDY PROCESS EMPLOYED BY DUKE ENERGY OHIO.

A. The electric distribution cost of service study assigns each component of revenue requirement formula to the various retail rate schedules. The components are directly assigned, or allocated, based on operational and/or accounting data with the objective being to allocate costs to customers in a manner that reflects the costs the Company incurs to serve them. The testimony of Duke Energy Ohio witness James E. Ziolkowski discusses Duke Energy Ohio's electric distribution cost of service study.

Q. WHAT ARE THE OBJECTIVES OF THE RATE DESIGN PROCESS?

A. The primary objectives of the rate design process are to develop rates that: (1) provide the utility with the opportunity to recover its annual revenue requirement; and (2) distribute the revenue recovery among customers within each retail rate schedule in a manner that is consistent with the cost of providing electric distribution service. Duke Energy Ohio witness James A. Riddle supports Duke

Energy Ohio's proposed rate design.

Q. MR. STEPHEN DE MAY SPONSORS DUKE ENERGY OHIO'S CONSOLIDATED CAPITAL STRUCTURE AS OF MARCH 31, 2012. WHY DO YOU RECOMMEND USING DUKE ENERGY OHIO'S CAPITAL STRUCTURE FOR ESTABLISHING RATES IN THIS PROCEEDING?

A. In addition to the long-standing precedent in Ohio for using the operating company's capital structure rather than the capital structure of the parent, I believe the Duke Energy Ohio consolidated capital structure is the appropriate capital structure to use as the basis for setting Duke Energy Ohio's electric distribution rates. The use of an alternative capitalization, such as Duke Energy's capital structure, would cause the rates in these proceedings to be impacted by a number of factors unrelated to Duke Energy Ohio's electric distribution operations. For instance, Duke Energy's capitalization reflects the practices and events of its regulated operations in Indiana, North Carolina, and South Carolina; its non-regulated domestic and international operations; and the spin-off of the gas pipeline businesses. It would be inappropriate to allow the capitalization practices and events in these affiliate activities to impact Duke Energy Ohio's electric distribution rates.

Q. IS THE COMPANY MAKING ANY ADJUSTMENTS TO DUKE ENERGY OHIO'S CONSOLIDATED CAPITAL STRUCTURE FOR RATE SETTING PURPOSES?

A. Yes. As described in the testimony of Company witness Daniel J. Reilly, Duke Energy Ohio's consolidated capital structure has been adjusted to eliminate the impact of: (1) purchase accounting recorded pursuant to the Duke Energy/Cinergy Corp (Cinergy)[2] merger; and (2) equity associated with Duke Energy North America generating assets acquired by Duke Energy Ohio in the 2006 Duke Energy/Cinergy merger (*i.e.*, the DENA assets). Although the DENA assets were transferred from being directly owned by Duke Energy Ohio to a subsidiary, there was no immediate impact on Duke Energy Ohio's consolidated balance sheet as these assets are still under the Duke Energy Ohio corporate structure and, therefore, should be removed.

Q. ARE THE ADJUSTMENTS TO THE CAPITAL STRUCTURE BEING PROPOSED HERE NEW?

A. No. Duke Energy Ohio has filed two retail rate cases since the Duke Energy/Cinergy Merger was consummated; one for electric distribution (Case No. 08-709-EL-AIR, *et al.*) and one for gas distribution (Case No. 07-589-GA-AIR, *et al.*). The capital structure adjustments being proposed in the current case are the same as adjustments made, and accepted by the Commission, in these two prior cases. It is worth noting that the impact of all these adjustments is to reduce the Company's equity ratio and, consequently, reduce the Company's jurisdictional revenue requirement.

Q. DESCRIBE THE IMPLICATIONS OF THE COMPANY'S COMMITMENT TO TRANSFER ITS LEGACY GENERATION ASSETS TO AN AFFILIATE, AS IT RELATES TO THIS RATE APPLICATION.

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[2] *In the Matter of the Joint Application of Cinergy Corp., on Behalf of the Cincinnati Gas & Electric Company, and Duke Energy Holding Corp. for Consent and Approval of a Change of Control of The Cincinnati Gas & Electric Company,* Case No. 05-732-EL-MER, *et al.*, Finding and Order (December 21, 2005).

A. As part of the Commission-approved stipulation in the Company's most recent standard service offer application, Case No. 11-3549-EL-SSO, *et al.*, Duke Energy Ohio agreed to transfer its direct ownership interest in all of its Legacy Generation fleet to an affiliate or subsidiary, by December 31, 2014.[3] As discussed by Company witness De May, the asset transfer will result in some recapitalization; however, as of the date of this filing, there is insufficient information upon which to base any adjustments to the Company's March 31, 2012, date certain capital structure to be used in this case. Consequently, the impending asset transfer has no impact on the rates being proposed in this rate application.

Q. AFTER ADJUSTING THE ACTUAL CAPITAL STRUCTURE TO ELIMINATE THE IMPACT OF PURCHASE ACCOUNTING AND TO ELIMINATE THE EQUITY ASSOCIATED WITH THE MIDWEST GAS ASSETS, WHAT IS THE CAPITALIZATION OF DUKE ENERGY OHIO FOR PURPOSES OF THESE PROCEEDINGS?

A. Duke Energy Ohio's consolidated capital structure at March 31, 2012, as adjusted, is approximately 46.70 percent debt and 53.30 percent common equity. This is shown on Schedule D-1.

It should be noted that the capital structure underlying the Company's requested revenue requirement is well above the limits established by the Federal Energy Regulatory Commission (FERC) and this Commission. The FERC and

[3] *In the Matter of the Application of Duke Energy Ohio, Inc., for Authority to Establish a Standard Service Offer Pursuant to Section 4928.143, Revised Code, in the Form of an Electric Security Plan, Accounting Modifications, and Tariffs for Generation Service,* Case No. 11-3549-EL-SSO, *et al.*, Stipulation and Recommendation (October 24, 2011).

this Commission imposed a minimum limit on the equity ratio of 30 percent. The limit reflects the FERC orders that approved the Duke Energy/Cinergy merger[4] and the Commission orders that approved an accounting modification to address the impact of required accounting treatment for the purchase accounting associated with the Duke Energy/Cinergy merger from 2006.[5]

IV. <u>NEW TARIFF PROPOSAL</u>

Q. PLEASE DESCRIBE THE SIGNIFICANT NEW RATE AND TARIFF THE COMPANY IS PROPOSING IN THESE PROCEEDINGS.

A. As part of its application in these proceedings, the Company is proposing to create a new tariff for relocating its facilities, Rider FRT, Facility Relocation – Mass Transportation. Duke Energy Ohio witness Harrell discusses the operational issues involved in the new tariff but, generally, the tariff seeks to ensure that the principles of cost causation are aligned with cost recovery. Traditional ratemaking necessarily involves a level of socialization for certain costs incurred by a utility. Utilities frequently have to relocate electric and gas facilities for private and public construction programs and, often, the cost is simply incorporated into base rates and recovered over all distribution rates. Other times, the cost to relocate is paid for directly by the party requesting the relocation and the utility's other customers have no burden for that cost.

Rider FRT focuses on recovery of the costs of relocations due to certain projects required by governmental subdivisions. In particular, Rider FRT will be

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[4] *Cincinnati Gas and Electric Company d/b/a Duke Energy Ohio and Union Light, Heat and Power Company, d/b/a Duke Energy Kentucky*, FERC Order, EL06-66-000.

[5] *In the Matter of Duke Energy Ohio's Application for Change in Accounting Methods*, Case No. 09-620-GE-AAM and Case No. 11-5985-GE-AAM.

a means for the Company to recover the cost of relocations associated with mass transportation projects initiated by governmental subdivisions. The rider is designed to give the governmental subdivision the option of paying the Company directly for the cost of relocation or, alternatively, to charge only those customers residing within its governmental boundaries for the cost of the project. For example, the city of Cincinnati (City) is requesting that Duke Energy Ohio relocate facilities, at considerable expense, to accommodate its proposed streetcar project. Under Rider FRT, the City will have the option either to pay for the cost directly to Duke Energy Ohio either in lump sum or over time (Option 1) or to allow the Company to collect, via a charge on the customers' bills, only from customers located within the city of Cincinnati, the cost of relocation over a period of time (Option 2). The charge under either option would be sufficient to pay for the cost of relocating the facilities, plus a carrying charge at the weighted-average cost of capital established in these proceedings.

Q. IS THE COMPANY PROPOSING RATES FOR RIDER FRT AT THIS TIME?

A. No. The tariff has not yet been approved by the Commission; consequently, no governmental entity has had the opportunity to utilize this tariff. Upon approval of this tariff, when an eligible governmental entity seeks the second option under the tariff, Duke Energy Ohio will submit its calculations to the Commission for its review and approval before implementing the charges. The Company will accrue carrying costs on any unrecovered balance of the eligible relocation cost until recovery is completed.

V. DEFERRAL REQUESTS

Q. IS THE COMPANY MAKING ANY NEW PROPOSALS REGARDING STORM COSTS?

A. Yes. As recent experience has shown, storm costs can be quite volatile and can have a significant impact on the Company's earnings. Duke Energy Ohio is proposing to establish a regulatory asset account to defer storm costs over a base amount to be established in the test year revenue requirement in these proceedings. To the extent storm costs are less than the amount in base rates, there will be a credit to the same account. Any monthly positive or negative balance in this deferral account would accrue a carrying cost at the Company's long-term cost of debt as approved in these proceedings. At the time of the Company's next base rate case, the balance of the regulatory asset, positive or negative, will be amortized over a period to be proposed by the Company and recovered in base rates to be set at that time.

Q. WHAT IS THE BENEFIT OF THIS PROPOSAL FOR CUSTOMERS AND/OR SHAREHOLDERS?

A. Storm costs are volatile. In 2008, Duke Energy Ohio's storm costs were over $30 million but, for the last four years, such costs have trended around $5 million, excluding the Hurricane Ike event in 2008. For the test year used in these proceedings, the amount of storm costs to be recovered in base rates is about $4.4 million. The test year is comprised mostly of budgeted data; so, it is reasonable that the storm cost in base rates should be fairly representative of the Company's expected storm costs and that the figure is fairly close to recent history supports that argument. There will be years when storm costs are lower than the amount being recovered in base rates and there will be years when storm costs are higher than the amount being recovered in base rates.

Storm costs can have a significant impact on the Company's ability to maintain the reliability of its distribution system. Although the Company includes an amount in its annual budgeting process to cover the cost of storms, a major storm event can create a challenge for the Company to fund other operating and capital needs of the utility in a given year. Allowing the Company to defer excessive storm costs in a given year (and offset the deferral when the storm costs are less than normal) is an equitable and sensible way of ensuring that the Company is not faced with an economic challenge to fund normal spending requirements to maintain its safe and reliable distribution system.

Q. HAS THE COMMISSION APPROVED THIS TYPE OF MECHANISM IN PRIOR CASES?

A. Yes. The Commission has recognized the importance of this type of mechanism in at least two prior electric cases. In Case No. 07-553-EL-AAM, *et al.*, the Commission approved a storm deferral mechanism for the First Energy operating companies and, more recently, in Case No. 11-346-EL-SSO, *et al.*, the Commission initially approved a stipulation that included a similar storm damage deferral mechanism request made by Ohio Power Company and Columbus Southern Power Company (now, collectively known as AEP Ohio) and supported by the Commission Staff.

VI. CONCLUSION

Q. HAVE YOU REVIEWED DUKE ENERGY OHIO'S APPLICATION IN THESE PROCEEDINGS?

A. Yes. I have also reviewed the testimony and exhibits of all witnesses. I believe that the Company's total electric distribution revenue requirement is properly computed, the costs of service are properly allocated to customer classes, and the rate design is equitable.

Q. DO YOU HAVE AN OPINION REGARDING WHETHER DUKE ENERGY OHIO'S RATE REQUEST IS REASONABLE?

A. Yes.

Q. PLEASE STATE YOUR OPINION.

A. Duke Energy Ohio's rate request is fair and reasonable. The date certain in Duke Energy Ohio's last rate case was March 31, 2008, and the date certain for this case is March 31, 2012. Despite the four years of inflationary pressures and substantial continuing capital investment in its distribution system, Duke Energy Ohio is requesting an overall increase in rates that will result in an approximate 5.1 percent over the total electric rates that customers now pay. Through aggressive cost management practices, the Company has been able to hold its increase request to a reasonable level.

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

A. Yes.