DUKE ENERGY OHIO EXHIBIT______

BEFORE

THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Commission's Investigation of the Financial Impact of the Tax Cuts and Jobs Act of 2017 on Regulated Ohio Utility Companies.	))))	Case No. 18-47-AU-COI

DIRECT TESTIMONY OF

WILLIAM DON WATHEN JR.

ON BEHALF OF

DUKE ENERGY OHIO, INC.

June 15, 2018

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I. INTRODUCTION

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 DESCRIBE YOUR EDUCATION 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 Duke Energy (then 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 DESCRIBE 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 its subsidiary, Duke Energy Kentucky, Inc.

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

A. Yes. I have 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. My testimony addresses the Commission's May 24, 2018, Entry in this proceeding, inviting Ohio's electric distribution utilities[1] (EDUs) to address the "narrow question of whether the utilities should be required to establish a deferred tax liability, effective January 1, 2018." I will discuss how Duke Energy Ohio is complying with that directive and recommend that the Commission consider its existing standard for granting utility deferrals in these circumstances.

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[1] Duke Energy Ohio, Ohio Power Company, Ohio Edison Company, The Cleveland Electric Illuminating Company, The Toledo Edison Company, and The Dayton Power & Light Company.

II. BACKGROUND

Q. WILL YOU DESCRIBE THE EVENTS THAT LED UP TO THE COMMISSION'S MAY 24, 2018, ENTRY?

A. The TCJA was enacted in December 2017. The new tax law includes a number of provisions that impact investor-owned utilities but the most significant ones are the reduction in the federal income tax rate from 35 percent to 21 percent and the elimination of certain accelerated depreciation mechanisms.

On January 10, 2018, the Commission issued an Entry (January Entry) that directed "the utilities . . . to record on their books as a deferred liability, in an appropriate account, the estimated reduction in federal income tax resulting from the TCJA," effective January 1, 2018.[2]

On February 9, 2018, the EDUs filed a joint application for rehearing (Joint Application for Rehearing) of the Commission's January Entry, requesting the Commission provide clarification on its deferral directive, intending to allow for the opportunity of due process and for informed decisions to occur.

On April 25, 2018, the Commission issued an Entry on Rehearing that, among other things, granted the EDUs' request for a hearing on the "narrow question of whether the utilities should be required to establish a deferred tax liability, effective January 1, 2018." The Commission denied the remainder of the issues raised by the EDUs in the Joint Application for Rehearing, finding them to be premature and more appropriate to be included in comments submitted in

[2] *In the Matter of the Commission's Investigation of the Financial Impact of the Tax Cuts and Jobs Act of 2017 on Regulated Ohio Utility Companies,* Case No. 18-47-AU-COI, Entry ¶7 (January 10, 2018).

this proceeding.[3]

On May 24, 2018, the Attorney Examiner issued an Entry inviting the EDUs to file testimony on the limited issue of addressing the requirement to record regulatory deferrals.

Q. DID THE COMMISSION PROVIDE ANY DIRECTION TO THE UTILITIES AS TO HOW THEY SHOULD CALCULATE THE IMPACTS OF THE TCJA?

A. No. The Commission's January Entry provided no instructions or guidance as to how the utilities should calculate the "deferred tax liability" associated with the TCJA, leaving each utility to perform its best informed analysis. The Commission's deferral directive did not provide for the consideration of actual financial impacts of the TCJA on Ohio's investor-owned utilities, which will be different (in some cases, significantly different) than the rate impacts to customers. This is because the changes resulting from the TCJA, (implications of reducing rates for lower income tax combined with loss of accelerated tax depreciation) materially impact the cash flow for utilities to continue funding ongoing operations and in meeting the coverage ratios to ensure access to capital and at reasonable rates. Customer rate reduction benefits in the near term may be at the cost of higher rates or deterioration in service in the long term if cash flow is unreasonably impaired.

Q. HAS THE COMPANY ATTEMPTED TO COMPLY WITH THE DIRECTIVE?

[3] Entry on Rehearing at 4.

A. Yes. The Company has made an attempt to comply with the January 10, 2018, Entry and has, since January 1, 2018, been recording a regulatory liability to reflect the impacts of the TCJA.

Q. PLEASE EXPLAIN HOW THE COMPANY HAS BEEN DEFERRING THE ESTIMATED REDUCTION IN FEDERAL TAXES RESULTING FROM THE TCJA.

A. The Company has been recording an estimate of the difference between the amount of federal income tax being collected in current rates at a 35 percent federal income tax (FIT) rate and the amount that would be collected if the current rates reflected a 21 percent FIT rate. The basis for deferrals comprises the impact of the TCJA on FIT rates currently reflected in base rates and riders before they were adjusted to reflect the TCJA.[4]

Q. PLEASE FURTHER EXPLAIN HOW DUKE ENERGY OHIO CALCULATED THIS DEFERRAL.

A. In order to estimate the dollar value of the impact of lowering the FIT rate from 35 percent to 21 percent on base rates and riders, the Company recalculated the revenue requirement from the most recent base rate cases and riders for electric distribution and for gas to estimate, as a percentage, the decrement to base revenue and riders that the lower FIT rate would create. It would be improper to attempt to record a deferral for the impact of the TCJA on actual taxable income earned by the Company since January 1, 2018, because (1) customer rates are not based on "actual" income taxes but are, instead, based on amounts included in the

[4] All of the Company's riders for gas and electric service that have an income tax component have been updated to reflect the lower FIT rates.

revenue requirement from the test year used in the most recent base rate case; and (2) there would be no way to calculate a monthly deferral until at least after quarterly tax returns are completed, because utilities do not pay actual income taxes every month.

Q. HAS DUKE ENERGY OHIO ALREADY STARTED TO REFLECT THE TCJA CHANGES IN CUSTOMER RATES?

A. Yes. Beginning April 1, 2018, the Company voluntarily updated four of its riders to reflect the lower FIT rate in the pre-tax return component of the revenue requirement for those riders. For electric customers, the Company's Distribution Capital Investment Rider (Rider DCI) and its Distribution Reliability – Infrastructure Modernization Rider (Rider DR-IM) were both updated to reflect the lower FIT rate and both were approved by the Commission for rates effective April 1, 2018. For gas customers, the Company's Advanced Utility Rider (Rider AU) was updated for the lower FIT rate and approved by the Commission for rates effective April 1, 2018, Its Accelerated Main Replacement Program Rider (Rider AMRP) was updated and approved by the Commission for rates effective May 1, 2018.

Q. DOES THE FACT THAT THE COMPANY BEGAN INCORPORATING THE LOWER FIT RATE IN ITS RIDERS IMPACT THE DEFERRALS FOR ITS BASE RATES?

A. Not for gas service but, because of how the formula works for calculating Rider DCI, customers began receiving most of the benefits attributable to its electric distribution revenue requirement from lowering FIT rate beginning April 1, 2018.

III. STATUS OF THE DEFERRALS

Q. WILL YOU QUANTIFY THE DEFERRALS THAT DUKE ENERGY OHIO HAS RECORDED TO DATE, IN ORDER TO COMPLY WITH THE COMMISSION'S JANUARY ENTRY?

A. Through March 31, 2018, the Company recorded approximately $6 million for its jurisdictional electric distribution business and $4.4 million for its jurisdictional gas business to reflect the lower FIT rates from the TCJA. The Company made other journal entries in December 2017 to reflect the impact of the TCJA on accumulated deferred income taxes (ADITs) but I am only addressing in this testimony the impact of the change in the lower FIT rate on ongoing revenue requirements for gas and electric service. As I discuss below, the accounting entries made in December 2017 were to reflect the impact of the TCJA on the Company's balance of ADITs. The creation of these deferrals in regulatory liability accounts followed generally accepted accounting principles.

Inasmuch as most of the impact to electric customers from reducing the FIT rate are flowing through Rider DCI and Rider DR-IM, the monthly deferrals for electric service since April 1, 2018, are significantly lower. It should also be noted that, because the Company is calculating the deferrals by applying a decrement percentage to the actual revenue collected, the monthly deferrals will vary along with the seasonal fluctuations in load.

The Company will continue making monthly deferral entries until either (1) the Commission issues a final order regarding the deferrals, or (2) the Company's rates fully reflect the lower FIT rate.

IV. STANDARD OF REVIEW FOR DEFERRALS

Q. DOES THE COMMISSION HAVE A STANDARD OF REVIEW FOR AUTHORIZING DEFERRALS?

A. Yes. As recently as April 18, 2018, the Commission issued an order, in Case No. 17-2118-GA-AAM[5] (Riverside Deferral Case), addressing its standards for reviewing deferral requests from utilities. Specifically, citing numerous prior decisions, the Commission indicated that:

> [it] evaluates applications for authority to establish a regulatory asset and to defer incurred expenses based primarily on a utility's demonstration of the following factors:
>
> > whether the utility's current rates or revenues are sufficient to cover the costs associated with the requested deferral;
> >
> > whether the costs are material;
> >
> > whether the reason for requesting the deferral is outside the utility's control;
> >
> > whether the expenses are atypical and infrequent; and
> >
> > whether the financial integrity of the utility will be significantly and adversely affected, if the deferral is not granted.[6]

Q. IN ORDERING THE DEFERRAL IN THIS PROCEEDING, DID THE COMMISSION APPLY THIS TEST FOR THE IMPACTS OF THE TCJA?

A. No. To date, there has been no finding or consideration of evidence related to its deferral criteria for any of the utilities. Duke Energy Ohio recommends that the Commission consider such evidence and follow this "five-factor test" to provide

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[5] *In the Matter of the Application of Duke Energy Ohio, Inc., for Approval to Change Accounting Methods*, Case No. 17-2118-GA-AAM, Finding and Order (April 18, 2018).
[6] *Id.*at ¶25.

equity, clarity and a reasonable standard that ensures both due process and informed decisions can occur. The Commission's criteria for considering and approving deferral requests, whether from a utility, or the Commission itself, should apply equally, regardless of whether the deferral is attributed to cost increases or decreases.

Q. HAVE YOU EVALUATED COMMISSION'S DIRECTIVE TO CREATE ACCOUNTING DEFERRALS IN THIS PROCEEDING BY APPLYING THE SAME STATED CRITERIA FOR APPROVING DEFERRAL REQUESTS FROM UTILITIES?

A. Yes. Applying the Commission's criteria for evaluating deferral requests for utility requests for deferrals to the deferrals directed in this proceeding suggests that the criteria that would support a deferral have not been met.

Q. PLEASE EXPLAIN.

A. To date, there has been no analysis or evidentiary record for the Commission to consider whether Duke Energy Ohio's current electric base distribution rates are sufficient to cover the costs associated with this deferral. The Commission only recently held to this standard in evaluating a deferral request from the Company. In evaluating the Company's deferral application in the Riverside Deferral Case, the Commission referenced the Staff's finding and stated that:

> Staff argues that Duke's application does not address whether or not revenue generated by its current rates is sufficient or insufficient to cover the expenses it is seeking to defer for the retaining wall. Staff notes that customers should not be expected to pay for a new expense, when the current rates already provide the utility with sufficient revenue.[7]

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[7] *Id.* at ¶18.

In the present case, the Commission's January Entry does not address whether or not ANY of the jurisdictional utilities' revenue generated at currently effective rates is sufficient or insufficient to cover the costs of utility service. Without finding that a utility's current revenues are sufficient to cover its expenses, the Commission has no basis to say whether or not this criterion has been met. The Commission should consider whether revenue from current rates exceeds the utilities' cost of service, including its authorized rate of return, prior to ordering deferrals.

Q. WITH RESPECT TO THE SECOND DEFERRAL CRITERION, HOW SHOULD THE COMMISSION CONDISER WHETHER OR NOT THE IMPACT OF THE LOWER FIT RATE HAS A MATERIAL IMPACT ON DUKE ENERGY OHIO'S ELECTRIC BUSINESS?

A. Although the Commission has not established an absolute threshold of what constitutes a "material" impact, it did conclude that the $3 million deferral request in the Riverside Deferral Case was not material. In that case, the Commission also faulted the Company for not addressing the materiality of the amount.

In determining that $3 million was not material for the gas business, the Commission referenced a Staff finding that $3 million was "less than one percent of the total operating expenses accounted for in Duke's current base rates."[8] Based upon this holding, anything below 1 percent of total operating expenses would presumably be immaterial. However, the Commission does not provide any guidance as to whether 2 percent is material, 3 percent is material, etc. It is

[8] *Id.* (referencing the Pre-Filed Testimony of Wm. Ross Willis, Schedule C-1 (April 22, 2013), in Case No. 12-1685-GA-AIR, *et al*.).

reasonable to assume that the greater the cost in relation to current base rates, the greater the likelihood that the impact should be considered material. The Commission should consider materiality of the deferral in relation to the impact of a utility's earnings to determine whether and to what extent the deferral amount creates a material impact on the utility's ability to provide service.

Q. HOW SHOULD THE COMMISSION EVALUATE WHETHER OR NOT THE REASONS FOR REQUESTING THE DEFERRAL OUTSIDE OF THE UTILITY'S CONTROL?

A. Certainly, the enactment of the TCJA was outside the control of either the Commission or the Company. However, in this case, the Commission is the entity requiring utilities to record accounting deferrals, and the reasons for the Commission to request deferral accounting are NOT outside of its control. The Commission has the authority to initiate a proceeding to evaluate whether a utility is earning above or below its required cost of service. It is entirely in the Commission's control whether or not there is a need to record deferrals in relation to the impact of the TCJA on the utility.

Q. HOW SHOULD THE COMMISSION CONSIDER WHETHER OR NOT THE EXPENSES AT ISSUE ARE ATYPICAL AND INFREQUENT?

A. It is fair to say that the "change" in the federal income tax rate is atypical and infrequent. However, it is entirely possible that the next election could bring some additional changes in the FIT rates. In any event, it is only the change that is atypical and infrequent; whether the FIT is 35 percent, 21 percent, or some other percent in the future, is highly likely that there will be some level of FIT in base rates. Again, changes in law happen and impact the utility's cost of service with some regularity. Although the Company is not suggesting the idea that "any possibility" of a recurrence of an infrequent and atypical event should nullify a deferral request, it must be noted that further changes in the federal income tax law are entirely possible as well.

Q. HOW SHOULD THE COMMISSION EVALUATE WHETHER OR NOT THE FINANCIAL INTEGRITY OF DUKE ENERGY OHIO WILL BE SIGNIFICANTLY AFFECTED IF THE DEFERRAL IS NOT GRANTED?

A. With respect to the applicability of that criterion to a situation where the deferral involves the accounting treatment of a reversal of a cost, the appropriate perspective should be whether or not granting/requiring the deferral will affect the financial integrity of the utility. A key component of such an analysis is whether the utility's existing revenues are just and reasonable. Again, as the Commission recently determined in Duke Energy Ohio's Riverside Deferral Case in evaluating the materiality of a deferral request, the Commission asserted that anything less than one percent of the operating expenses included in a utility's base rates was "immaterial." Presumably, the same materiality/immateriality threshold should hold true for a potential savings that would represent less than one percent of customers' bills.

Q. DOES THE COMMISSION'S TEST FOR EVALUATING DEFERRALS HAVE ANY BEARING ON DUKE ENERGY OHIO'S GAS BUSINESS?

A. Although the magnitude of the savings is relatively greater using the Commission's measure of materiality (*i.e.*, percent of operating expenses included in base rates), this is not an issue the Commission addressed in its January Entry for any of the utilities impacted by that Entry.

V. OTHER TCJA DEFERRALS

Q. DID THE TCJA RESULT IN ANY ACCOUNTING DEFERRALS OTHER THAN THOSE YOU ARE DISCUSSING HERE?

A. Yes. The Company was required to adjust its balance sheet to write down its accumulated deferred income taxes to reflect the fact that the lower FIT rate will reduce its deferred tax obligation. At the same time, the Company created a corresponding regulatory liability, in Account 254, to reflect the fact that these "excess" accumulated deferred income taxes are stilled owed to customers.

Because this adjustment in December 2017 was simply a transfer from one balance sheet account to another balance sheet account, the "deferred" nature of these deferred liabilities did not change. Therefore, no Commission order or action was needed to transfer this regulatory liability from one account to another.

It is my expectation that the ultimate resolution of refunding the excess accumulated deferred income taxes will be resolved at another stage of the Commission's review in this proceeding or in separate, utility-specific proceedings.

VI. CONCLUSION

Q. PLEASE SUMMARIZE YOUR RECOMMENDATIONS REGARDING THE CREATION OF THE DEFERRAL FOR THE TCJA STEMMING FROM THE COMMISSION'S JANUARY ENTRY?

A. The Commission should apply its existing deferral standard and allow due process to occur. The Commission should not simply base its decision to direct any deferral without a standard that applies equally. To date, the Commission has not received evidence in this regard and therefore lacks necessary information to make an informed decision. The Commission's January Entry did not consider the sufficiency of Duke Energy Ohio's electric or gas revenues to cover its costs of service. It did not consider whether the amounts at issue are material or whether the requirement to create the deferral impacts the Company's financial integrity. The Commission can initiate a proceeding on its own to review the existing rates of a utility to determine if the impacts of the TCJA result in excess earnings. While the change in the FIT rate may be atypical and infrequent "there is no guarantee" that the rates will not change again.

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

A. Yes.