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PUCO

VIA OVERNIGHT DELIVERY

January 21, 2008

Public Utilities Commission of Ohio
Docketing Division
13th Floor
180 East Broad Street
Columbus, OH 43215-3716

Re: In the Matter of the Application of Duke Energy Ohio, Inc. for an Increase in Gas Rates, Case No. 07-589-GA-AIR

In the Matter of the Application of Duke Energy Ohio, Inc. for Approval of an Alternative Rate Plan for its Gas Distribution Service, Case No. 07-590-GA-ALT

In the Matter of the Application of Duke Energy Ohio, Inc. for Approval to Change Accounting Methods, Case No. 07-591-GA-AAM

Dear Sir or Madam:

Enclosed please find an original and 22 copies of Duke Energy Ohio, Inc.'s Objections to Staff Report of Investigation and Summary of Major Issues for filing in the above-referenced cases. Please date-stamp and return the two extra copies in the enclosed overnight envelope.

Sincerely,

John Finnigan

John J. Finnigan, Jr.
Associate General Counsel

JJF/bsc
cc: All counsel of record (w/encl.)

BEFORE THE

PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application of Duke Energy Ohio, Inc. for an Increase in Rates	)))	Case No. 07-589-GA-AIR
In the Matter of the Application of Duke Energy Ohio, Inc. for Approval of an Alternative Rate Plan for its Gas Distribution Service	))))	Case No. 07-590-GA-AIR
In the Matter of the Application of Duke Energy Ohio, Inc. for Approval to Change Accounting Methods	)))	Case No. 07-591-GA-AAM

DUKE ENERGY OHIO, INC.'S
OBJECTIONS TO
STAFF REPORT OF INVESTIGATION
AND SUMMARY OF MAJOR ISSUES

Pursuant to R.C. 4909.19, O.A.C. 4901-1-28 and the Attorney Examiner's Entries dated December 21, 2007, and January 7, 2008, Duke Energy Ohio, Inc. ("DE-Ohio") submits the following Objections to the Staff Report of Investigation ("Staff Report") and summary of major issues. DE-Ohio reserves the right to contest issues that are newly raised between the filing of the Staff Report and the closing of the record. At the outset, DE-Ohio would like to thank the Commission Staff and Blue Ridge Consulting Services, Inc. ("Blue Ridge") for their prompt, detailed and highly professional review of the Company's application.

OBJECTIONS TO STAFF REPORT

REVENUE REQUIREMENT

(1.) **Amount of Staff's Proposed Revenue Increase**. DE-Ohio objects to the revenue increase range of $14,271,220 to $20,050,312 recommended by Staff. Staff's proposed revenue increase significantly understates the magnitude of the increase to which DE-Ohio is entitled and which DE-Ohio supported in its Standard Filing Requirements. As more specifically described in the following objections, Staff's recommended increase results from unreasonable, unlawful and erroneous adjustments that would result in rates that are insufficient to provide DE-Ohio just compensation or an opportunity to earn an adequate return for providing safe, adequate and reliable natural gas service for its customers.

RATE BASE

(2.) **Common Plant Allocation Factor**. DE-Ohio objects to Staff's recommendation to change the Common Plant allocation factor from the 18.68% used in DE-Ohio's application to 13.50% recommended by Blue Ridge. Blue Ridge recommended this adjustment to update the factor used by DE-Ohio, which was based on 2004 data. Using more recent data from 2006, without any adjustments, results in a factor of 13.50%. DE-Ohio does not object to updating this factor using 2006 data; however, certain adjustments must be made to be consistent with the rest of the filing and to avoid misallocating common costs related to the provision of gas distribution service. Specifically, DE-Ohio adjusted its capital structure to eliminate the impact of the generating plants contributed to DE-Ohio by Duke Energy North America, LLC ("DENA"). This adjustment to capital structure was made in order to ensure that the Company complied with commitments it made for approval of the 2006 merger[1] that no costs associated with the transfer of the assets formerly owned by DENA can be passed on to DE-Ohio's customers.

Similar to the adjustment to capital structure, the Common Plant allocation factor must also be adjusted to eliminate the impact of the contributed generating plants. Using 2006 plant data, adjusted to eliminate the plants formerly owned by DENA, the updated Common Plant allocation factor that Staff should have recommended is 18.29%. Staff's proposal to update the Common Plant allocation factor for 2006 data is reasonable if so adjusted. If the Staff's proposed factor is not adjusted to eliminate the DENA plants, then Staff's proposal is inconsistent with other adjustments in the filing and significantly understates DE-Ohio's net gas plant-in-service for determining the proper amount of rate base.

Second, as a practical matter, the assets formerly owned by DENA have little, or nothing, to do with the use of Common Plant and therefore such amounts should not be included in the development of

[1] *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 (Finding and Order at 15) (December 21, 2005).

Common Plant allocation factors intended to allocate the investment to those activities for which the facilities are being utilized.

(3.) **Working Capital**. DE-Ohio objects to Staff's recommendation that no allowance should be made for working capital in rate base because DE-Ohio did not file a lead/lag study. DE-Ohio does not object to this Staff recommendation to the extent that the recommendation applies solely to the cash component of working capital. Indeed, DE-Ohio does not seek to include cash working capital in rate base and DE-Ohio did not file a lead/lag study for this reason. DE-Ohio does object, however, to Staff's recommendation because it also impacts non-cash working capital. DE-Ohio has significant non-cash working capital investment which is properly included in rate base even in the absence of a lead/lag study.

Working capital includes various non-cash items such as fuel supplies, gas stored underground, and prepayments. These balances represent a significant ongoing investment by the Company. For example, during the 13-month period involved in the present case, DE-Ohio averaged $49 million in investment for gas stored underground. DE-Ohio objects on the following grounds:

(a.) Staff's failure to recognize any non-cash working capital is arbitrary and unreasonable because it substantially understates DE-Ohio's investment required to provide natural gas service to customers. Staff should recognize all of the non-cash working capital because DE-Ohio properly documented its non-cash working capital investment in its application;

(b.) Staff should have recommended that carrying costs on the Company's investment in gas storage be recovered through DE-Ohio's Gas Cost Recovery Rate ("Rider GCR") to avoid any subsidization of DE-Ohio's Rider GCR customers by all distribution customers. Such recommendation would be consistent with the treatment Staff supported for Vectren Energy Delivery of Ohio, Inc., in Case Nos. 04-220-GA-GCR and 05-220-GA-GCR. Applying this method will allow recovery of a return on gas stored underground but not on cash or other working capital items; or,

(c.) Staff should estimate cash working capital by applying the lead/lag time cycles from DE-Ohio's last gas rate case in 2001. A similar proposal was advocated by the Office of Consumers' Counsel ("OCC") in the Company's most recent electric distribution case.[2] DE-Ohio's revenue collection and accounts payable practices have not changed materially since that time and are consistent with other Ohio natural gas utilities' practices. Estimating cash working capital in this manner would provide a reasonable basis for estimating this component of rate base.

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[2] *In the Matter of the Application of The Cincinnati Gas & Electric Company for an Increase in Electric Distribution Rates,* Case No. 05-059-EL-AIR (OCC Objections to Staff Report at 3) (October 11, 2005).

OPERATING INCOME

(4.) **Depreciation Expense.**

(a) **Failure to Include Net Salvage in Depreciation Accrual Rates**. Under composite depreciation accounting methodology, a depreciation accrual rate is calculated by subtracting the net salvage value percentage from 100%, then dividing the result by the asset's average service life. Although it appears to be a clerical error, Staff failed to include net salvage value in its calculation of DE-Ohio's depreciation accrual rates. This omission caused DE-Ohio's annualized depreciation expense to be significantly understated.

(b) **Common Plant Allocation**. Staff's use of an incorrect Common Plant allocation factor, as discussed above, inappropriately reduces the Company's annualized depreciation expense. Correcting the Common Plant allocation factor will remedy this error.

(5.) **Weatherization Expense**. DE-Ohio objects to Staff's failure to recognize $1 million for weatherization expense in the Company's revenue requirement. DE-Ohio proposed an additional $1 million in weatherization funding as part of its commitments to support the Company's alternative regulation plan, which consists of various trackers. DE-Ohio included an adjustment to test period expenses to reflect the additional $1 million in weatherization funding. Staff recommended that the additional $1 million in weatherization funding should be recovered from the Company's shareholders rather than customers, as part of the Company's commitments to support its alternative regulation plan. DE-Ohio requested approval of these trackers as part of its base rate application as well as under its alternative regulation plan (*see* Objection No. 10, *infra*). To the extent that the Commission approves the trackers under DE-Ohio's base rate application, then DE-Ohio should be permitted to reflect the full cost of its weatherization funding in its test period operating expenses for purposes of establishing DE-Ohio's rates. To the extent that the Commission approves the trackers under DE-Ohio's alternative regulation plan, DE-Ohio believes that its existing commitments are sufficient to support the alternative regulation plan.

(6.) **Gross Revenue Conversion Factor**. DE-Ohio objects to Staff's calculation of the Gross Revenue Conversion Factor because Staff failed to include the PUCO and OCC maintenance fees when calculating the Gross Revenue Conversion Factor. If the Company recovers more revenue, it will incur higher PUCO and OCC maintenance fees, all else being equal. Consequently, these maintenance fees should be reflected in the Gross Revenue Conversion Factor calculation in order to allow DE-Ohio to recover these increased maintenance fees through its revenues.

(7.) **Amortization Period for Certain Expenses**. Staff changed the amortization period for two categories of test year expenses: (a.) curb-to-meter and riser replacement costs incurred during the test year; and (b.) rate case expenses. DE-Ohio proposed to amortize these expenses over three years but Staff recommended a five-year amortization period. DE-Ohio submits that a three-year amortization period is reasonable, and is consistent with past Commission precedent. In fact, the Staff recently recommended a three-year amortization of such expenses in its Staff Report in the current First Energy electric distribution case.[3]

(8) **Property Taxes**. Staff's use of an incorrect Common Plant allocation factor, as discussed above, inappropriately reduces the Company's annualized property tax expense. Correcting the Common Plant allocation factor will remedy this error.

RATE OF RETURN

(9.) **Cost of Equity**. DE-Ohio objects to the cost of equity used by Staff in its cost of capital analysis because Staff failed to apply generally accepted methods for accurately estimating the cost of equity as follows:

(a.) Staff did not consider the evidence submitted by DE-Ohio in support of the Company's proposed cost of equity.

(b.) Staff only considered the Discounted Cash Flow ("DCF") and Capital Asset Pricing Model ("CAPM") models for estimating the cost of equity, and did not consider other models proposed by DE-Ohio.

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[3] *In the Matter of the Application of Ohio Edison Company, The Cleveland Electric Illuminating Company, and The Toledo Edison Company for Authority to Increase Rates for Distribution Service, Modify Certain Accounting Practices and for Tariff Approval,* Case No. 07-551-EL-AIR (Staff Report at 13) (December 4, 2007).

(c.) Staff used different criteria for selecting comparison group companies than used by DE-Ohio, without explaining its reasons for rejecting DE-Ohio's criteria.

(d.) Staff's DCF model understates DE-Ohio's cost of equity because the Market-to-Book ("M/B") ratio of the utility stocks used in the analysis exceeds one.

(e.) Staff used the annual version of the DCF model, rather than the quarterly version of the DCF model, causing an understatement of the cost of equity by 20 basis points.

(f.) Staff used an average 12-month stock price in the DCF model. The use of such a stock price does not comply with market efficiency principles and results in a mismatch of stock price and expected growth. The proper stock price to employ is the current price of the security at the time of estimating the cost of equity.

(g.) Staff's CAPM Market Risk Premium is slightly understated because it relies on total bond returns rather than on the income component of bond returns.

(h.) Staff's "plain vanilla" version of the CAPM understates return requirements for companies with beta estimates less than 1.0, such as utility companies like DE-Ohio. Staff should have applied an Empirical CAPM analysis.

(i.) Staff's DCF estimates of equity costs are downward-biased by approximately 10 basis points because Staff's analysis ignores the market pressure component of flotation costs.

(j.) Staff arbitrarily adjusted its cost of equity estimate downward by 42 basis points, purportedly to reflect DE-Ohio's risk profile in relation to the risk profile of Staff's comparison group companies, without providing any discussion or analysis of why DE-Ohio was less risky than the other companies or why 42 basis points is an appropriate downward risk adjustment.

RATES AND TARIFFS

(10.) **Trackers as Part of Base Rate Application**. Staff failed to address DE-Ohio's tracker proposals as part of the Company's base rate application. Rather, Staff reviewed the tracker proposals only in the context of DE-Ohio's alternative regulation plan. DE-Ohio filed its tracker proposals as part of its base rate application as well as part of its alternative regulation plan; therefore, Staff should have analyzed the tracker proposals in the context of both applications. Significantly, DE-Ohio is not required to support tracker proposals filed under a base rate application with Company commitments. The Commission has approved similar tracker proposals in other cases as part of base rate applications.

(11.) **Rider AU – Meter Costs**. Staff recommended approval of DE-Ohio's proposed Rider AU to recover the costs of deploying the Utility of the Future project. The rider will be set at a zero balance at this time and will not be adjusted until the Company files, and the Commission approves, a deployment plan and an application for a Rider AU revenue increase. The Staff Report states that, if Company employees discover inoperative or incompatible meters when installing the advanced metering equipment, and the meters need to be repaired or replaced, such meter costs should not be recovered through Rider AU. This would not prevent the Company from timely recovering its Utility of the Future costs relating to gas service, because the Company generally does not intend to replace gas meters under the Utility of the Future program.

The Company objects to Staff's statement, however, because the Company will apply at a later date for a similar tracking mechanism to recover the cost of deploying the Utility of the Future program for electric service. DE-Ohio expects to replace all electric meters as part of the Utility of the Future deployment. New electric meters will be a major portion of DE-Ohio's costs for deploying this program for electric service.

These costs will be significant, will be incurred within a short time period, will not be fully offset by increased revenues, and would not be incurred but for the Utility of the Future program. DE-Ohio therefore submits that it would be appropriate for the Commission to allow DE-Ohio to recover new meter costs as part of a tracking mechanism to deploy a smart grid system for electric service and the Commission should allow tracker recovery of gas meter costs (if any) for the sake of consistency with similar future trackers for electric service.

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(12.) **<u>Construction Period for Riser Replacement/AMRP Programs</u>**. DE-Ohio proposed a construction period of nine years for the accelerated riser replacement program and the balance of the AMRP program (covering years 2007 through 2015). Staff recommended that the riser replacement program be completed in three years. DE-Ohio submits that the most efficient and practicable method for accomplishing the Staff's objective would be to extend the AMRP construction period to the end of 2016 and to complete the riser replacement program by the end of 2012. This would allow DE-Ohio to effectively manage these programs with existing contractors using competitive bidding, and would avoid the additional and unnecessary expense of paying new contractors mobilization costs for bringing work crews to this area. Given that other natural gas utilities are performing accelerated riser and gas main replacement work, DE-Ohio's proposed construction schedule would place less pressure on contractor resources and would tend to keep costs lower not only for DE-Ohio's riser and gas main replacement programs, but also for similar programs of other Ohio utilities. DE-Ohio further submits that this construction schedule recognizes safety considerations because DE-Ohio has been following programs to replace the highest risk risers since 2004 and highest risk AMRP mains since 2000.

(13.) **<u>Revenue Distribution – Residential Subsidy</u>**. DE-Ohio proposed a revenue distribution that would eliminate the residential subsidy over three years, in equal one-third increments each year. Staff recommended that only two-thirds of the residential subsidy be eliminated. DE-Ohio objects that the Staff did not support fully eliminating the residential subsidy. DE-Ohio continues to maintain that, under generally accepted utility rate design principles, the rates for each customer class should fully reflect the costs of serving that class, and that all inter-class subsidies should be eliminated.

(14.) **Decoupled Rate Design**. DE-Ohio proposed a revenue decoupling tracker, and Staff responded by recommending a primarily fixed decoupled rate design. DE-Ohio generally accepts Staff's recommended rate design concept because this would allow DE-Ohio to collect a greater proportion of its fixed costs through fixed customer charges, and because customers would receive the appropriate pricing signal in a timely manner rather than be subject to a decoupling tracker rate in a subsequent year. DE-Ohio objects, however, to the Staff's decoupling concept rate design in the following respects:

(a.) Customers using less than 50 ccf of natural gas, annually, should not have a lower customer charge than other customers because the cost incurred by DE-Ohio to serve these low-use customers is identical to the cost for serving customers using larger volumes of gas;

(b.) General Service customers should be served under two separate usage-based tariffs rather the four usage categories recommended by Staff: one for customers using less than 4,000 ccf, annually, and one for customers using 4,000 ccf and above, annually. This is a reasonable dividing point between small and large General Service customers and would allow DE-Ohio to implement the new rates with minimal costs to re-program its billing system. The Staff Report correctly noted that a significant change in the rate design might require billing system modifications. In the alternative, if the Commission rejects this objection, DE-Ohio requests approval to recover its costs for re-programming its billing system.

(c.) DE-Ohio objects to Staff's failure to recommend approval of a revenue decoupling tracker, even if their primarily fixed decoupling rates are implemented. Under Staff's proposed rate design, the revenues collected through fixed customer charges would not cover DE-Ohio's fixed costs. DE-Ohio would continue to collect a material portion of its revenues through volumetric charges, and a revenue decoupling tracker would still be necessary to address the steady decline in customer usage.

OTHER

(15.) **Audit of Service Company Charges and Allocations**. Blue Ridge recommended that the Commission order DE-Ohio to conduct an audit of service company charges and allocations. DE-Ohio submits that such an audit is unnecessary. The Staff Report did not recommend any such audit. Blue Ridge "reviewed and validated the jurisdictional, organizational, and functional allocation factors used in distributing service organization costs to DE-Ohio."[4] Aside from minor corrections, Blue Ridge also verified the accuracy of DE-Ohio's revenue requirement proposal. DE-Ohio therefore should not be required to incur the unnecessary time and expense for conducting an audit of service company charges and allocations.

(16.) **Completed Construction Not Classified ("Account 106") and Retirement Processing**. Blue Ridge recommended that DE-Ohio reduce the number of work orders and the dollar value of work orders in Account 106 to a more reasonable level. It also recommended that DE-Ohio establish an estimate of plant that should be retired in connection with each work order classified in Account 106 as of the date certain in this case. DE-Ohio objects to this recommendation as unnecessary and incorrect. The vast majority of the work orders in Account 106 at the date certain in this case are related to the AMRP. The work orders were maintained in Account 106 to allow for identification of the AMRP investment until such plant investment is included in DE-Ohio's rate base. Since the filing of this case, DE-Ohio has closed the March 31, 2007 balance of these work orders to Account 101, Plant In-Service. Only work orders placed in service after March 31, 2007, and additional

[4] *In the Matter of the Application of Duke Energy Ohio, Inc. for an Increase in Rates,* Case No. 07-589-GA-AIR (Report of Conclusions and Recommendations on the Financial Audit of Duke Energy Ohio, Inc. in Regard to Case No. 07-0589-GA-AIR at 9) (December 17, 2007).

charges to work orders in service at that date will be included in future Rider AMRP filings.

As to the recommendation that retirements be estimated, DE-Ohio processes all AMRP-related retirements immediately after the plant is taken out of service, even though the work order remains in Account 106. Blue Ridge's calculation of $13.8 million of estimated retirements that should have been booked is incorrect because these retirements actually have been booked, if the plant is no longer in service. As such, Blue Ridge's estimate of the $356,000 reduction in depreciation expense related to these retirements is also incorrect.

Blue Ridge references a proposal by Staff in the PUCO Staff Report of Investigation in Case No. 01-1228-GA-AIR to adjust plant for un-booked retirements. The reason for Staff's proposal in that case was to correct for retirements that were not recorded since a new Fixed Asset System was implemented approximately nine months before the date certain. In that case, DE-Ohio agreed and the adjustment for $3.9 million of non-recorded retirements was accepted. This adjustment was not related to work orders in Account 106 for which retirements had not been booked.

(17.) **Filing Date for Next Rider AMRP Application**. DE-Ohio objects to the Staff's failure to address the issue regarding timing of the Company's next Rider AMRP filing. The Company filed a pre-filing notice in November 2007 to increase the Rider AMRP rate. The base rate application covered AMRP plant in-service through March 31, 2007. The November 2007 pre-filing notice covered AMRP plant in-service from April 1, 2007, through December 31, 2007. DE-Ohio filed the November 2007 pre-filing notice because this was consistent with the Commission's schedule for the annual Rider AMRP filings established in Case No. 01-1228-GA-AIR.

DE-Ohio filed a motion in this proceeding on November 30, 2007, addressing the issue of whether the November 2007 pre-filing notice overlaps with the present base rate application. DE-Ohio's motion requested that, if the Commission determined that the applications were overlapping, then the November 2007 pre-filing notice should be held in abeyance and the filing date for the application should be extended to the earlier of: (a.) April 21, 2008, or (b.) after a final order is issued in the base rate case. The OCC filed a memorandum contra on December 17, 2007, arguing that DE-Ohio's November 2007 pre-filing notice violates R.C. 4909.18 because it results in overlapping rate applications, and also because it violates the stipulation in Case No. 01-1228-GA-AIR. DE-Ohio filed a reply memorandum on December 27, 2007; so, the issue is fully briefed and ripe for Commission determination.

DE-Ohio objects that the Staff Report failed to address this issue. DE-Ohio incorporates the arguments raised in its motion and reply memorandum, and raises the following points in support of its position:

(a.) DE-Ohio's motion complies with R.C. 4909.18 because DE-Ohio's July 17, 2007 application seeks to decrease the Rider AMRP surcharge;

(b.) DE-Ohio's motion complies with R.C. 4909.18 because the need to continue the accelerated main and riser replacement program can be considered an emergency due to the safety-related aspects of the programs;

(c.) Revised Code Section 4909.18 does not apply because DE-Ohio filed its application to continue Rider AMRP as an alternative regulation program;

(d.) Revised Code Section 4929.11 renders R.C. 4909.18 inapplicable;

(e.) DE-Ohio's motion complies with the stipulation in Case No. 01-1228-GA-AIR because the stipulation only dealt with Rider AMRP increases through May 2007; and

(f.) If the Commission accepts either of OCC's arguments, then the Commission should hold the notice of intent in abeyance until the earlier of: (a.) April 21, 2008, or (b.) after a final order is issued in the base rate case.

SUMMARY OF MAJOR ISSUES

(1.) The fair amount of revenue increase to which DE-Ohio is entitled.

(2.) The appropriate value of DE-Ohio's used and useful assets for providing natural gas service to customers, including common plant and working capital.

(3.) The appropriate level of operating expenses allowable for ratemaking purposes.

(4.) The proper return on equity to be used in determining DE-Ohio's allowable rate of return.

(5.) The appropriate rate design.

(6.) The appropriate distribution of revenue increases among customer classes.

(7.) In addition to Staff's recommended approval of the trackers as part of DE-Ohio's alternative regulation proposal, whether DE-Ohio's tracker proposals should also be approved as part of the Company's general gas rate case.

(8.) Whether DE-Ohio should be permitted to recover meter replacement costs as part of its Utility of the Future tracker.

(9.) Whether DE-Ohio should be permitted to proceed with its pending Rider AMRP pre-filing notice covering the last nine months of 2007.

(10.) Whether the Commission should adopt Blue Ridge's audit recommendations.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I certify that a copy of the foregoing Duke Energy Ohio, Inc.'s Objections to Staff Report of Investigation and Summary of Major Issues was served on the following parties of record by electronic mail and by ordinary United States mail, postage prepaid, this 21st day of January 2008.

John J. Finnigan, Jr.

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