

BEFORE

THE PUBLIC UTILITIES COMMISSION OF OHIO

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

SETTLEMENT SUPPORTING TESTIMONY OF

PAUL G. SMITH

ON BEHALF OF

DUKE ENERGY OHIO, INC.

_____	Management policies, practices, and organization
_____	Operating income
_____	Rate Base
_____	Allocations
_____	Rate of return
_____	Rates and tariffs
<u> x </u>	Other

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INDEX

Settlement supporting testimony relating to the reasonableness of a Stipulation and Recommendation entered into between DE-Ohio and other parties to these cases.

TABLE OF CONTENTS

	<u>PAGE</u>
I. INTRODUCTION AND PURPOSE.....	- 1 -
II. DISCUSSION.....	- 2 -
III. CONCLUSION	- 13 -

I. INTRODUCTION AND PURPOSE

1 **Q. PLEASE STATE YOUR NAME.**

2 A. My name is Paul G. Smith.

3 **Q. DID YOU FILE DIRECT AND SUPPLEMENTAL TESTIMONY IN THIS**
4 **PROCEEDING ON BEHALF OF DUKE ENERGY OHIO INC. (“DE-**
5 **OHIO” or “COMPANY”)?**

6 A. Yes.

7 **Q. WHAT IS THE PURPOSE OF YOUR SETTLEMENT SUPPORTING**
8 **TESTIMONY IN THIS PROCEEDING?**

9 A. The purpose of my Settlement Supporting Testimony is to discuss and support the
10 reasonableness of a Stipulation and Recommendation (“Stipulation”) entered into
11 among DE-Ohio, the Staff of the Commission, and all of the other Parties who
12 have intervened in DE-Ohio’s application for an increase in gas rates, which have
13 been consolidated in the above-captioned proceedings. This testimony will
14 demonstrate that: (1) the Stipulation is a product of serious bargaining among
15 capable, knowledgeable parties; (2) the Stipulation does not violate any important
16 regulatory principle or practice; and (3) the Stipulation, as a whole, will benefit
17 customers and the public interest. Additionally, I explain the Company’s position
18 with respect to several issues raised in this proceeding which are resolved by the
19 Stipulation or still pending before the Commission.

1 **II. DISCUSSION**

2 **Q. PLEASE GENERALLY DESCRIBE THE STIPULATION.**

3 A. This Stipulation, filed with the Commission on February 28, 2008, represents a
4 resolution of all but one of the issues among the Parties relating to the Company's
5 application for an increase in gas rates and alternative regulation plan. Except
6 where specifically noted otherwise, the terms of the Stipulation adopt the
7 recommendations made by the Staff Report of Investigation ("Staff Report") in
8 this proceeding.

9 In summary, the Stipulating Parties agree that DE-Ohio shall increase its
10 annual gas distribution base rates by approximately \$18.2 million. Such increase
11 will eliminate, over a two-year period, \$6 million, or roughly one-third, of the
12 residential subsidy as reflected in the Company's revised cost of service study.

13 The Stipulation provides that DE-Ohio will file its actual Accelerated
14 Main Replacement Program ("AMRP") data for the last nine months of 2007.
15 The data will support an adjustment of Rider AMRP, which will be implemented
16 effective May 1, 2008, subject to refund.

17 The Stipulation resolves all issues in the case except for the issue of the
18 fixed vs. volumetric rate design and/or a sales decoupling rider, which will be
19 litigated and decided by the Commission.

20 **Q. DOES THE STIPULATION REPRESENT A PRODUCT OF SERIOUS**
21 **BARGAINING AMONG CAPABLE, KNOWLEDGEABLE PARTIES?**

22 A. Yes. The parties to the Stipulation include all parties to the case: the Commission
23 Staff, DE-Ohio, the Office of the Ohio Consumers' Counsel ("OCC"), Ohio

1 Partners for Affordable Energy ("OPAE"), People Working Cooperatively, the
2 City of Cincinnati, the Ohio Energy Group, The Kroger Co., Interstate Gas
3 Supply, Integrys Energy, Direct Energy Services and Stand Energy. The Parties
4 regularly participate in rate proceedings before the Commission, and are
5 knowledgeable in regulatory matters. The Parties were represented by
6 experienced, competent counsel. Furthermore, the Parties represent a broad range
7 of interests.

8 The Commission Staff has thoroughly reviewed DE-Ohio's application,
9 with the assistance of an independent, outside financial auditor with significant
10 experience auditing utility companies. Many of the Parties who signed the
11 Stipulation were also involved in the Company's 2002 rate proceeding (Case No.
12 01-1228-GA-AIR) in which the current base rates and Rider AMRP were
13 established, and such Parties are knowledgeable about DE-Ohio's gas operations
14 and gas rate structure. All Parties were invited to attend all of the settlement
15 discussions regarding the rate application. DE-Ohio held its first settlement
16 conference at the office of the Commission on January 25, 2008. Several
17 subsequent Settlement discussions occurred at the office of the Commission or via
18 teleconference. All of the issues in these cases were addressed during these
19 meetings. The Stipulation is a compromise resulting from those discussions and
20 therefore represents a product of capable, knowledgeable parties.

21 As a result of the Stipulation, DE-Ohio will recover substantially less
22 revenue than it requested in its rate application in these proceedings. Many of the
23 Parties, as demonstrated in their objections to the Staff Report, sought a result in

1 which DE-Ohio would have received substantially less revenue than DE-Ohio
2 will receive under the Stipulation. In addition, the Stipulation contains many
3 provisions which benefit customers yet were not part of DE-Ohio's application,
4 but instead were included in the Stipulation as a result of serious bargaining by
5 the other Parties. The Stipulation therefore represents a reasonable compromise
6 among the Parties.

7 **Q. DOES THE STIPULATION VIOLATE ANY IMPORTANT**
8 **REGULATORY PRINCIPLE OR PRACTICE?**

9 A. No. The Stipulation complies with all relevant and important principles and
10 practices. The Stipulation is fully supported by all of the evidence presented to
11 the Commission in this case by DE-Ohio and by the other signing Parties.

12 **Q. HOW DOES THE STIPULATION COMPLY WITH IMPORTANT**
13 **REGULATORY PRINCIPLES AND PRACTICES?**

14 A. The Stipulation provides for an annual increase in base rates of approximately
15 \$18.2 million, even though the Company fully supported an increase of \$34.1
16 million in its rate application and standard filing requirements. The Stipulation
17 provides for an extension of Rider AMRP through 2018 to continue recovering
18 costs associated with its accelerated cast iron and bare steel pipe replacement
19 program. This tracking mechanism was originally approved by the Commission in
20 Case No. 01-1228-GA-AIR. The Stipulation also allows the Company to recover
21 the costs of its accelerated riser replacement program through Rider AMRP,
22 subject to certain residential rate caps.

1 **Q. DOES THE STIPULATION BENEFIT CONSUMERS AND THE PUBLIC**
2 **INTEREST?**

3 **A.** Yes. The Stipulation provides numerous significant benefits across all customer
4 groups. The primary benefits include: first, customers will experience a
5 substantially lower base rate increase than DE-Ohio had supported in its rate
6 application and standard filing requirements. DE-Ohio sought a \$34.1 million
7 base rate increase; however, DE-Ohio will obtain a much lower base rate increase
8 of only \$18.2 million under the Stipulation.

9 Second, DE-Ohio's rate application requested base rate recovery of the
10 carrying cost incurred to maintain gas inventory in storage, computed at the
11 Company's pre-tax weighted average cost of capital of 12.18%. Pursuant to the
12 Stipulation, DE-Ohio will recover such carrying cost as a component of the gas
13 cost recovery ("GCR") rider, but will only earn a 10% rate of return; a much
14 lower rate than its overall cost of capital. The transfer of this cost recovery from
15 DE-Ohio's base rates to Rider GCR ensures comparability of commodity costs
16 with marketers who necessarily build into their price the cost of maintaining gas
17 storage. Additionally, such transfer ensures that only those customers benefiting
18 from the gas storage will actually bear the cost, rather than forcing all distribution
19 customers to subsidize GCR customers. This outcome benefits marketers as well
20 as the large percentage of customers who have selected an alternative commodity
21 supplier. This outcome also benefits GCR customers because it helps put the
22 marketers' price on the same footing as the Company's GCR price, thereby
23 enhancing competition and customer choice.

1 Third, the Stipulation includes a relatively fixed charge residential rate
2 design for the non-commodity portion of the bill, which OCC and OPAE
3 expressly oppose. Notwithstanding this opposition, the relatively fixed residential
4 rate design provides several benefits including: (1) the rate design more closely
5 aligns the price signal, and revenue recovery, with the fixed cost structure of
6 providing gas distribution service; (2) the rate design benefits low-income
7 customers by resulting in a lower bill for those customers whose volume typically
8 exceeds the residential average; (3) the rate design benefits all residential
9 customers by reducing distribution costs during the winter heating season when
10 natural gas bills are the largest; (4) the rate design mimics the fixed price that
11 customers appear to prefer in other common services such as cable TV, telephone,
12 internet, satellite radio and cell phone; (5) the rate design mitigates the effect of
13 persistently declining average residential throughput which prevents DE-Ohio
14 from the opportunity to earn its allowed return; (6) provides the benefit identified
15 in (5) above without requiring the time and cost associated with the periodic filing
16 of a decoupling tracker; and (7) maintains a significant incentive for residential
17 customers to implement economical energy efficiency measures without
18 inappropriately subsidizing such customers at a significant burden to all other
19 residential customers, including those on low or fixed incomes. To summarize,
20 the Stipulation's relatively fixed rate design benefits all residential customers,
21 especially those customers with low or fixed incomes and those customers whose
22 usage is above the average.

1 Fourth, the Stipulation benefits non-residential customers by eliminating
2 \$6 million of the existing residential customer subsidy. Based on the Company's
3 updated cost of service study, non-residential customers are currently subsidizing
4 residential customers by approximately \$19 million. Eliminating \$6 million of
5 the subsidy over a two-year period will ensure that non-residential customers
6 benefit by addressing at least some of the subsidy/excess issue, which is in
7 keeping with the regulatory principle of establishing rates based on cost causation.
8 Conversely, residential customers benefit by gradually eliminating the subsidy
9 and limiting the rate shock that could otherwise be experienced, which is in
10 keeping with the regulatory principles of gradualism and designing rates to
11 provide accurate price signals.

12 Fifth, the Stipulation benefits all gas distribution customers through the
13 continuance of the Rider AMRP, and by including recovery of costs incurred to
14 replace certain risers. The Stipulation identifies a reasonable customer revenue
15 allocation for these two programs which ensures that residential and non-
16 residential customers are appropriately charged and that neither customer class
17 subsidizes the other. Rider AMRP also benefits customers because it is
18 symmetrical, in that the Company not only recovers the costs of the AMRP and
19 the accelerated riser replacement program, but also flows through to customers
20 the benefit of associated maintenance savings and a reduced return on the AMRP
21 and riser investment corresponding to the accumulated depreciation.
22 Additionally, the Stipulation identifies a Rider AMRP rate cap for residential
23 customers that limit the Company's ability to recover program costs through the

1 tracking mechanism, while ensuring the timely completion of this important
2 safety, reliability and efficiency program. The two programs, taken together,
3 require significant capital expenditures over a relatively short time period. The
4 Company's ability to recover these investments on a timely basis will allow DE-
5 Ohio to remain in sound financial condition. In turn, the trackers will keep the
6 Company's cost of capital from increasing, and mitigates the need for frequent
7 rate increases that otherwise might be required.

8 Sixth, the Stipulation provides for DE-Ohio to begin assuming ownership
9 of curb-to-meter services and risers. This will allow the Company to ensure that
10 good utility practice is followed in installing and maintaining this equipment.
11 This change in policy will be a relief to customers insofar as customers who
12 owned the service lines and risers typically would not replace the equipment until
13 it failed. By allowing DE-Ohio to own this equipment, the Company will be able
14 to replace the equipment proactively and at no direct cost to the customer. This
15 change will also result in a lower Rider AMRP revenue requirement for several
16 years.

17 Seventh, the Stipulation creates a placeholder for a new tracking
18 mechanism known as Rider AU ("Advanced Utility"). This rider will allow DE-
19 Ohio to receive timely cost recovery for deploying a smart grid system which will
20 provide numerous benefits, including reduced meter reading costs. DE-Ohio's
21 service area is largely urban with a significant number of hard to access inside
22 meters. The Company maintains keys to thousands of customer homes to allow
23 the Company access to read inside meters. Entering customer homes, and the

1 Company's inability to access other inside meters, creates many customer service
2 and billing issues that DE-Ohio will now be able to avoid.

3 Eighth, the Stipulation benefits low-income customers by establishing a
4 low-income pilot program that provides an incentive to stay off of programs such
5 as Percentage Income Payment Plan ("PIPP"). All residential customers will
6 benefit from this program by avoiding PIPP increases that might otherwise occur
7 without such a program.

8 Ninth, the Stipulation benefits all residential customers by identifying
9 numerous customer-friendly commitments. These commitments span a broad
10 range of issues including: avoiding the use of payday lenders as authorized
11 payment stations when other suitable locations are available in the same
12 geographic area, coordinating the administration of Demand Side Management
13 and Energy Efficiency programs, and discussing with Staff the elimination of
14 customer deposits for PIPP customers.

15 Tenth, the Stipulation benefits all customers by accelerating a projected
16 reduction in future depreciation rates. Due primarily to the AMRP, the average
17 remaining depreciable life of the system has increased, thereby allowing the
18 Company to reduce the required depreciation rates, and annual depreciation
19 expense, included in base rates. In its application, DE-Ohio proposed to reduce
20 its annual depreciation expense approximately \$2 million to reflect the benefit
21 associated with the first half of the AMRP program. This Settlement provides for
22 an additional \$2 million reduction in depreciation expense, which is roughly

1 equivalent to accelerating the projected benefit that will occur once the AMRP
2 program is completed.

3 Eleventh, the Stipulation benefits all customers by establishing a working
4 group to explore the merits of implementing an auction to supply the standard
5 service offer.

6 Twelfth, the Stipulation benefits all GCR and choice customers by
7 ensuring the continuation of a sharing mechanism for net revenues from off-
8 system transactions should DE-Ohio not have an asset management agreement for
9 its gas commodity, storage and transportation contracts.

10 **Q. DO YOU BELIEVE THE STIPULATION MEETS THE THREE-PART**
11 **TEST REGARDING CONSIDERATION OF PARTIAL STIPULATIONS**
12 **AND SHOULD BE ADOPTED BY THE COMMISSION?**

13 **A.** Yes, I do.

14 **Q. DOES THE STIPULATION RESOLVE ALL OF THE ISSUES IN THIS**
15 **PROCEEDING?**

16 **A.** No, it does not. As I previously mentioned, the Stipulation addresses most, but
17 not all, issues in this proceeding. Specifically, OCC and OPAE expressly oppose
18 the higher fixed charge rate design. The City of Cincinnati takes no position with
19 respect to this issue.

20 **Q. DO YOU BELIEVE THE RELATIVELY HIGHER FIXED CHARGE IS**
21 **AN APPROPRIATE RATE DESIGN?**

22 **A.** Yes, I do. A relatively fixed charge rate design is appropriate for a capital-
23 intensive service with very little variable costs, such as gas distribution. In this

1 proceeding, the cost of service justifies a fixed monthly price in excess of \$30;
2 however, the Staff Report recommendation of \$20.25 in year 1, and \$25.33 in
3 year 2, as reflected in Stipulation Exhibit 2, is reasonable and consistent with the
4 regulatory principle of gradualism. Although a much higher fixed charge rate is
5 justified, DE-Ohio is willing to accept the additional risk associated with the
6 stipulated lower fixed charge rate without demanding a decoupling mechanism to
7 mitigate the persistent decline in average residential usage.

8 **Q IS THE RATE DESIGN PROPOSED IN THE STIPULATION**
9 **CONSISTENT WITH THE REGULATORY PRINCIPLE OF COST**
10 **CAUSATION?**

11 **A** Yes. The higher fixed charge rate design appropriately recognizes that the cost to
12 serve residential customers is effectively the same, regardless of a specific
13 residential customer's usage. Stated differently, the cost to serve two neighboring
14 residential customers is virtually identical, regardless of the respective customer's
15 usage. Both customers are served from the same gas mains, utilize the same
16 compression and regulating equipment, and are served by the same meter reading,
17 billing and customer service operations. DE-Ohio's cost to serve these two
18 residential customers is identical and therefore there is no practical reason that
19 their monthly bills should differ.

20 **Q. DOES THE HIGHER FIXED CHARGE RATE DESIGN ADVERSELY**
21 **IMPACT LOW INCOME CUSTOMERS?**

22 **A.** No, it does not for several reasons. First, an analysis of PIPP customer data
23 indicates that the average PIPP customer consumes approximately 1,000 ccf per

1 year, which is approximately 25% more than the average non-PIPP customer.
2 The Commission's approval of the proposed monthly fixed charge rates will
3 actually reduce the annual cost to the average PIPP customer.

4 Second, the low-income pilot program unanimously supported by the
5 Stipulation reduces the potential adverse financial impact to all but a small
6 percentage of the low-usage customers. In fact, this innovative program results in
7 a rate decrease to the average low-income customer.

8 Third, the rate design specified in the Stipulation benefits all customers,
9 especially those with low and fixed incomes, by spreading distribution costs more
10 evenly throughout the year. By leveling the distribution component of the bill
11 throughout the year, the proposed rate design reduces the customer bill during the
12 winter heating season when natural gas bills are the largest. Accordingly, the
13 proposed higher fixed charge rate design partially addresses, but does not fully
14 resolve, a common complaint by low and fixed income customers that the high
15 natural gas bills during the winter months exceed their ability to pay.

16 **Q. DOES THE HIGHER FIXED MONTHLY CHARGE REDUCE THE**
17 **INCENTIVE FOR CUSTOMERS TO PURSUE ENERGY EFFICIENCY**
18 **MEASURES?**

19 A. No, it does not for several reasons. First, the single largest component of a
20 customer's gas bill is the natural gas commodity. Over 60%, and as much as
21 80%, of the customer's bill is driven by the variable cost of the commodity.
22 Because the proposed distribution rate design retains a sizable variable
23 component, the customer's total bill is predominantly driven by usage.

1 Accordingly, if the rate design recommended in the Stipulation is approved,
2 reducing usage will result in a significant savings to the customer, and is not
3 likely to alter the customer's decision to pursue energy efficiency measures.

4 Second, by more accurately pricing the distribution component to reflect
5 the underlying fixed costs of providing this service, the customer receives a more
6 accurate marginal cost price signal. By providing an accurate marginal cost price
7 signal, customers are better able to manage their energy efficiency decisions.

8 Third, the high volumetric rate proposed by OCC and OPAE will create
9 revenue subsidization among residential customers. DE-Ohio does not believe
10 the forced subsidization of energy efficiency initiatives by non-participants is
11 appropriate, or desired by residential customers.

12 Fourth, the decoupling recommendation supported by the OCC effectively
13 produces the same result as the higher fixed charge rate design. Whereas the
14 OCC would propose a mechanism whereby reduced residential usage impacts all
15 residential customers in a subsequent year following the implementation of any
16 energy efficiency measures, the fixed charge recommended in the Stipulation
17 eliminates price volatility, avoids inter-class subsidization, and avoids the
18 complexity, cost and administrative burden of processing and litigating the
19 decoupling filings.

20 III. CONCLUSION

21 Q. DOES THIS CONCLUDE YOUR SETTLEMENT SUPPORTING
22 TESTIMONY?

23 A. Yes.

CERTIFICATE OF SERVICE

I certify that a copy of the foregoing Settlement Supporting Testimony of Paul G. Smith was served on the following parties of record by electronic filing and by e-mail, this 28th day of February 2008.

/s/ John J. Finnigan, Jr.
John J. Finnigan, Jr.

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Summary: Testimony of Paul Smith Supporting the Stipulation electronically filed by ANITA M SCHAFER on behalf of Finnigan, John J. Mr.