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DE-OHIO EXHIBIT _____

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BEFORE

THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application of Duke Energy Ohio for an Increase in Electric Distribution Rates)	Case No. 08-709-EL-AIR
)	
In the Matter of the Application of Duke Energy Ohio for Tariff Approval)	Case No. 08-710-EL-ATA
)	
In the Matter of the Application of Duke Energy Ohio for Approval to Change Accounting Methods)	Case No. 08-711-EL-AAM
)	

DIRECT TESTIMONY OF

STEPHEN G. DE MAY

ON BEHALF OF

DUKE ENERGY OHIO

- _____ Management policies, practices, and organization
- _____ Operating income
- _____ Rate Base
- _____ Allocations
- _____ Rate of return
- _____ Rates and tariffs
- X Other: capital structure, credit quality and related matters

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INDEX

Testimony sponsoring credit quality, capitalization, capital requirements, credit ratings and related matters.

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I. INTRODUCTION AND PURPOSE

1 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

2 A. My name is Stephen G. De May, and my business address is 526 South Church
3 Street, Charlotte, North Carolina 28202.

4 **Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?**

5 A. I am employed by Duke Energy Corporation (Duke Energy) affiliated companies
6 as Vice President and Treasurer.

7 **Q. PLEASE SUMMARIZE YOUR EDUCATION AND PROFESSIONAL
8 QUALIFICATIONS.**

9 A. I have a Bachelor of Arts degree in Political Science from the University of North
10 Carolina in Chapel Hill, North Carolina, and a Master of Business Administration
11 degree from the McColl School of Business at Queens University in Charlotte,
12 North Carolina. I am a Certified Public Accountant (CPA) in the state of North
13 Carolina and I am a member of the American Institute of Certified Public
14 Accountants and the North Carolina Association of Certified Public Accountants.

15 **Q. PLEASE SUMMARIZE YOUR WORK EXPERIENCE.**

16 A. My professional work experience began in 1986 with the public accounting firm
17 of Price Waterhouse (now PricewaterhouseCoopers) and, subsequently, Deloitte,
18 Haskins and Sells (now Deloitte & Touche), where my work focused on tax
19 accounting and consulting for a variety of clients, including C-corporations, S-
20 corporations, partnerships, and high-net-worth individuals. In 1990, I joined
21 Crescent Resources Inc., a then-wholly-owned real estate development subsidiary
22 of Duke Power Company (a predecessor company to today's Duke Energy) where

1 I was responsible for real estate accounting and finance. In 1994, I moved to the
2 Treasury and Corporate Finance department where I have held, except for a two-
3 year period of time, various positions of increasing responsibility. The two-year
4 exception was for the majority of 2004 and 2005, during which time I had the lead
5 responsibility for developing and managing Duke Energy's energy and regulatory
6 policies. I was named to my current position in 2007.

7 **Q. PLEASE DESCRIBE YOUR DUTIES AS VICE PRESIDENT AND**
8 **TREASURER.**

9 A. As Vice President and Treasurer, I am responsible for treasury and risk
10 management-related services to Duke Energy and its subsidiaries, including Duke
11 Energy Ohio (DE-Ohio or Company). Under my supervision, we arrange and
12 execute all capital raising and liquidity transactions, including credit facilities and
13 commercial paper, debt securities, preferred and hybrid securities, and common
14 stock, as well as daily cash management. My responsibilities include managing
15 Duke Energy's and its subsidiaries' credit ratings and relationships with the major
16 credit rating agencies, commercial banks, and the capital markets. I am
17 responsible for overall risk management oversight of Duke Energy through the
18 identification, quantification, monitoring, and reporting of financial, market, and
19 credit risks across the enterprise. My responsibilities also encompass finance-
20 related due diligence for major capital expenditure proposals as well as corporate
21 merger, acquisition, or divestiture transactions. Finally, my responsibilities
22 include the oversight and administration of investments supporting Duke Energy's
23 pension and retirement benefit plans and nuclear decommissioning trust funds.

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

3 A. Yes. Most recently, I provided testimony in support of DE-Ohio's gas rate case
4 application in case number 07-589-GA-AIR.

5 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS
6 PROCEEDING?

7 A. My testimony addresses DE-Ohio's credit quality, capital structure, and cost of
8 capital. I also discuss the forecast of DE-Ohio's capital requirements as well as
9 DE-Ohio's financial objectives. I sponsor Schedules D-1A, D-1B, D-2A, D-2B,
10 D-3A, D-3B, D-4A, and D-4B. I also sponsor Supplemental Filing Requirement
11 (C)(3).

II. DE-OHIO'S CREDIT QUALITY, CAPITALIZATION,
AND COST OF CAPITAL

12 Q. HOW DO THE CREDIT RATING AGENCIES AND OTHERS ASSESS
13 CREDIT QUALITY?

14 A. DE-Ohio's creditworthiness is an assessment by the credit rating agencies and
15 other creditors of its financial strength, including its ability to raise capital and
16 meet its future financial obligations, and its ability to withstand changes in its
17 business environment. Many qualitative and quantitative factors go into such an
18 assessment. Qualitative aspects may include DE-Ohio's regulatory climate, its
19 track record for delivering on its commitments, the strength of its management
20 team, its operating performance, and the strength of its service area. Quantitative
21 measures are primarily based on operating cash flow and focus on DE-Ohio's
22 ability to meet its fixed obligations (such as interest expense) on the basis of

1 internally-generated cash and the level at which DE-Ohio maintains debt leverage
2 in relation to its generation of cash. Interest coverage ratios and the percentage of
3 debt to total capital are examples of quantitative measures. Creditors and credit
4 rating agencies generally view both qualitative and quantitative factors in the
5 aggregate when assessing the credit quality of a company.

6 **Q. HOW WAS DE-OHIO'S CAPITAL STRUCTURE DEVELOPED FOR**
7 **PURPOSES OF THIS CASE?**

8 **A.** For purposes of this filing, DE-Ohio's capital structure is presented on an operating
9 company basis, as opposed to a holding company basis. More specifically, DE-
10 Ohio's consolidated capital structure is used as the basis for this filing. The capital
11 structure presentation is supported by the testimony of DE-Ohio witness Mr. Paul G.
12 Smith.

13 **Q. WHAT EFFECT DO CAPITAL STRUCTURE AND RETURN ON**
14 **EQUITY HAVE ON CREDIT QUALITY?**

15 **A.** Capital structure and return on equity are important components of credit quality.
16 Equity investors provide the foundation of a company's capitalization by
17 providing significant amounts of capital for which an appropriate economic return
18 is required. Returns to equity investors are realized only after all operating
19 expenses and fixed payment obligations (e.g., debt principal and interest) of the
20 business have been paid. Because these investors are the last to receive surplus
21 earnings and cash flows, it is their capital that is most at risk if the company
22 suffers a downturn in business or general economic conditions. This dynamic of
23 equity investors receiving "residual" earnings and cash flows provides debt

1 investors a measure of protection. Therefore, the greater the equity component of
2 capitalization, the safer the returns are to debt investors, which translates into
3 higher credit quality. In addition, the allowed return on equity is a key component
4 in the generation of earnings and cash flows. An adequate return on equity helps
5 ensure equity investors receive fair compensation for the capital they have at risk
6 while at the same time helping to protect debt holders. A strong capital structure
7 and an adequate return on equity provide balance sheet protection and cash flow
8 generation to support high credit quality. High credit quality creates financial
9 flexibility by providing more readily available access to the capital markets on
10 reasonable terms, and ultimately lower debt financing costs.

11 **Q. DO YOU BELIEVE THAT DE-OHIO'S CONSOLIDATED CAPITAL**
12 **STRUCTURE HAS AN ADEQUATE EQUITY COMPONENT TO**
13 **ENABLE DE-OHIO TO ACHIEVE THE COMPANY'S FINANCIAL**
14 **STRENGTH AND CREDIT QUALITY OBJECTIVES?**

15 A. Yes. DE-Ohio's existing equity component enables it to maintain current credit
16 ratings and financial strength and flexibility. This level of equity will enable DE-
17 Ohio to tolerate the volatility of different business cycles while also providing a
18 cushion to the Company's lenders and bondholders.

19 **Q. DOES THE CAPITAL STRUCTURE AS FILED IN THIS PROCEEDING**
20 **REFLECT A VIEW OF DEBT AND EQUITY THAT IS IDENTICAL TO**
21 **THAT CALCULATED BY THE RATING AGENCIES?**

22 A. No. As discussed in the testimony of DE-Ohio witness Mr. Paul G. Smith, DE-
23 Ohio developed its capital structure for purposes of this filing to include

1 adjustments related to the Duke Energy/Cinergy Corp. merger. These are
2 adjustments that would not be made in the credit rating agencies' calculation of
3 DE-Ohio's capital structure. In addition, in calculating the debt component of
4 capital structure, the credit rating agencies include short-term debt and current
5 maturities of long-term debt and then impute *pro-forma* debt amounts to include
6 in their capital structure calculations for long-term fixed obligations, which they
7 consider to be "debt equivalents." Examples of "debt equivalents" would include
8 certain operating lease obligations, long-term purchased power agreements, and
9 under-funded pension plan obligations. Credit rating agency calculations of
10 capital structure typically result in a higher debt component. The increased
11 leverage imputed by the agencies reinforces the need for a strong equity
12 component in DE-Ohio's capital structure.

13 **Q. WHAT IS DE-OHIO'S CONSOLIDATED COST OF LONG-TERM DEBT**
14 **AS OF MARCH 31, 2008?**

15 A. DE-Ohio's consolidated cost of long-term debt as of March 31, 2008 is 6.45%. This
16 is down from the 6.77% cost of long-term debt in DE-Ohio's last electric
17 distribution rate case in 2005 (based on the date certain of September 30, 2004 used
18 in Case No. 05-59-EL-AIR).

19 **Q. IN DE-OHIO'S GAS RATE APPLICATION IN CASE NUMBER 07-589-GA-**
20 **AIR, DE-OHIO'S CONSOLIDATED COST OF LONG-TERM DEBT AS OF**
21 **MARCH 31, 2007 WAS 5.87%. WHY DID DE-OHIO'S CONSOLIDATED**
22 **COST OF LONG-TERM DEBT CHANGE BETWEEN MARCH 31, 2007**
23 **AND MARCH 31, 2008?**

1 A. The primary difference between the cost of long-term debt as of March 31, 2007 and
 2 March 31, 2008, is due to the exclusion of pollution control bonds from the
 3 calculation of DE-Ohio's cost of long-term debt for purposes of this case. The
 4 pollution control bonds are directly related to electric generation, which is not a part
 5 of this case requesting an increase in electric distribution rates, so it is appropriate to
 6 exclude them as part of the calculation. This treatment is consistent with the cost of
 7 long-term debt calculation that was filed in DE-Ohio's last electric distribution rate
 8 case in 2005, Case No. 05-59-EL-AIR.

9 Q. **WHAT IS DE-OHIO'S COST OF EQUITY FOR THE PURPOSES OF THIS**
 10 **FILING?**

11 A. DE-Ohio witness Dr. Roger A. Morin supports a cost of equity of 11.0 % for this
 12 proceeding.

III. DE-OHIO'S CURRENT CREDIT RATINGS

13 Q. **HOW ARE DE-OHIO'S OUTSTANDING SECURITIES CURRENTLY**
 14 **RATED BY THE CREDIT RATING AGENCIES?**

15 A. As of the date of this testimony, DE-Ohio's outstanding debt is rated by Standard &
 16 Poor's (S&P) and Moody's Investors Service (Moody's) as follows:

<u>Rating Agency</u>	<u>S&P</u>	<u>Moody's</u>
Senior Unsecured Rating	A-	Baa1
Ratings Outlook	Stable	Stable
Last Ratings Action	Ratings Upgraded in May 2007	Ratings Affirmed in April 2006; Outlook Changed to Stable from Positive in January 2008

1 **Q. PLEASE EXPLAIN WHAT IS MEANT BY THESE CREDIT RATINGS**
2 **FOR DE-OHIO'S CONSOLIDATED LONG-TERM DEBT.**

3 A. Obligations carrying an "A" credit rating are considered upper-medium grade
4 investment securities subject to low credit risk for the investor. "A" rated debt is
5 presumed to be somewhat susceptible to changes in circumstances and economic
6 conditions; however, the debt issuer's capacity to meet its financial commitments is
7 considered strong.

8 *S&P may also modify its ratings with the use of a plus or minus sign to*
9 *further indicate the relative standing within a major rating category. An "A+" credit*
10 *rating is at the higher end of the "A" credit rating category and an "A-" is at the*
11 *lower end of the category. Moody's credit rating assignments use the numbers "1",*
12 *"2", and "3", with the numbers "1" and "3" analogous to a "+" and "-", respectively.*
13 *For example, Moody's credit ratings of "A2" and "A3" would be analogous to "A"*
14 *and "A-" credit ratings at S&P, respectively.*

15 **Q. WHAT IS MEANT BY A "STABLE" OR "POSITIVE" OUTLOOK?**

16 A. A rating outlook assesses the potential direction of a long-term credit rating over
17 an intermediate term (typically six months to two years). A "Stable Outlook"
18 indicates the credit ratings are not likely to change over the intermediate term.

19 **Q. DID THE DUKE ENERGY/CINERGY CORP. MERGER AFFECT DE-**
20 **OHIO'S CREDIT RATINGS?**

21 A. No. The existing credit ratings for DE-Ohio's senior unsecured debt at the time of
22 the merger were "BBB" and "Baa1" by S&P and Moody's, respectively, and both

1 S&P and Moody's affirmed those credit ratings at the time of the merger.

2 **Q. WHAT FACTORS CAUSED S&P TO CHANGE DE-OHIO'S CREDIT**
3 **RATINGS IN MAY 2007?**

4 A. The rating action by S&P in May 2007 was the result of its view that Duke Energy
5 experienced a significant reduction in business risk due to the disposal of various
6 high-risk businesses and the significant de-leveraging of Duke Energy through the
7 spin-off of its gas company (Spectra Energy Corp). S&P raised the credit ratings on
8 Duke Energy and all its subsidiaries (including DE-Ohio). The S&P action resulted
9 in the credit ratings on secured and unsecured debt for Duke Energy and its
10 subsidiaries (including DE-Ohio) to be upgraded from "BBB+" and "BBB",
11 respectively, to "A" and "A-", respectively.

12 **Q. WHAT FACTORS CAUSED MOODY'S TO CHANGE DE-OHIO'S**
13 **RATINGS OUTLOOK IN JANUARY 2008?**

14 A. The positive financial outlook, which was originally assigned in April 2006, largely
15 incorporated Moody's view that the financial performance of Duke Energy and its
16 subsidiaries would improve over the next several years. The Moody's rating action
17 in January 2008 stated that given increased capital investment plans and Moody's
18 expectation that these capital investments will be financed without a discrete
19 issuance of Duke Energy common equity, Moody's believes Duke Energy's and its
20 subsidiaries' (including DE-Ohio) key financial credit metrics are no longer
21 expected to improve, but will remain reasonably stable over the near- to
22 intermediate-term horizon.

1 **Q. HAVE THE CREDIT RATING AGENCIES RAISED ANY CONCERNS**
2 **ABOUT DE-OHIO?**

3 A. Yes. Both S&P and Moody's have expressed concerns associated with the
4 uncertainty surrounding the expiration of DE-Ohio's rate stabilization plan at the
5 end of 2008. However, this concern has been mitigated somewhat by the passage of
6 Amended Senate Bill 221 (S.B. 221). In its April 24, 2008 press release, S&P
7 stated that S.B. 221 was a favorable event for the credit quality of the state's electric
8 utility industry as it provides incremental clarity to electric utility companies after
9 2008. Furthermore, Moody's stable rating outlook reflects Moody's "expectation
10 that the Ohio regulatory/legislative intervention will be resolved in a collaborative
11 manner without any negative implications."

12 The credit rating agencies have also expressed concern with DE-Ohio's
13 exposure to high environmental compliance costs, as a result of DE-Ohio's reliance
14 primarily on coal-fired generation. In general, the credit rating agencies have noted
15 the general importance of timely and adequate recovery of all prudent and approved
16 costs, including environmental compliance costs, as being important to credit
17 quality.

18 **Q. WHY IS IT IMPORTANT FOR DE-OHIO TO HAVE HIGH**
19 **INVESTMENT-GRADE CREDIT RATINGS?**

20 A. High investment-grade credit ratings provide DE-Ohio with greater financial
21 flexibility, lower debt financing costs, and greater access to the capital markets
22 and are a key component of DE-Ohio's ability to maintain a low-cost level of safe,
23 reliable customer service. Strong credit ratings are essential to being able to raise

1 debt capital on reasonable terms, under different market conditions, to fund
2 infrastructure requirements and to refinance maturing debt.

3 **Q. DO YOU EXPECT THE OUTCOME OF THE CURRENT RATE**
4 **PROCEEDING TO HAVE ANY SUBSTANTIAL IMPACT ON THE**
5 **COMPANY'S CREDIT RATINGS?**

6 A. No, assuming the Commission approves a constructive outcome. I believe a
7 strong equity component of the capital structure and the cost of equity as
8 requested in this filing will support our objective of having strong credit ratings.
9 The following excerpt provides key points made by S&P in their February 27,
10 2008 summary report on DE-Ohio:

11 The stable outlook on Duke Energy Ohio mirrors the outlook of its
12 parent, Duke Energy. The stable outlook on Duke Energy reflects
13 the company's excellent business risk profile and expectations of
14 credit-protection measures over the intermediate term that supports
15 the current rating. Given the company's increasing focus on
16 regulated operations, Standard & Poor's Ratings Services expects
17 that the company will pursue constructive regulatory decisions to
18 avoid meaningful increases in business risk, and thereby preserve
19 its financial profile. If business risk increases (either through a
20 material, unfavorable regulatory outcome or the pursuit of
21 unregulated operations) or the financial profile weakens, the
22 outlook will be revised to negative and ratings may be lowered. A
23 higher rating is not contemplated, especially in light of Duke
24 Energy's large capital spending program.
25

26 DE-Ohio's credit ratings reflect the agencies' view that the Commission's
27 regulation of the Company will be constructive. Moody's ranks the quality of the
28 regulatory environment in Ohio as a 3, on a scale of 1 through 4 (where 1 is
29 considered the most supportive). Assuming such a constructive outcome is

1 achieved, I do not believe that this proceeding will adversely impact DE-Ohio's
2 credit ratings.

IV. DE-OHIO'S CAPITAL REQUIREMENTS

3 **Q. WHAT ARE DE-OHIO'S UNCONSOLIDATED CAPITAL**
4 **REQUIREMENTS DURING THE 2008-2013 TIME PERIOD?**

5 A. DE-Ohio's unconsolidated capital requirements are projected to be approximately
6 \$3.4 billion during the period 2008-2013. This amount consists principally of
7 approximately \$2.7 billion in projected capital expenditures and approximately \$700
8 million in debt maturities (including capital lease maturities) from 2008-2013.

9 **Q. HOW WILL DE-OHIO'S UNCONSOLIDATED CAPITAL**
10 **REQUIREMENTS BE FUNDED?**

11 A. DE-Ohio's unconsolidated capital requirements during the 2008-2013 period are
12 expected to be partially funded from internal cash generation, net of dividends, of
13 approximately \$2.1 billion with the balance of approximately \$1.3 billion to be
14 funded principally from the issuance of debt (both short-term and long-term).
15 Equity funding requirements, to the extent they are required to maintain an
16 appropriate capital structure for DE-Ohio, may be satisfied through either a
17 reduction in the dividends DE-Ohio pays to its parent or through the receipt of
18 equity contributions from its parent.

V. DE-OHIO'S FINANCIAL OBJECTIVES

1 **Q. WHAT ARE DE-OHIO'S FINANCIAL OBJECTIVES?**

2 A. DE-Ohio's overall financial objective is to maintain financial strength with assured
3 and reasonable access to low cost capital in order to continue to provide cost-
4 effective, safe, adequate, environmentally-compliant, and reliable service to our
5 customers. Specific financial objectives necessary to maintain financial strength
6 include: (a) maintaining current credit ratings; (b) maintaining sufficient cash flows
7 to meet obligations; and (c) maintaining a sufficient return on equity to fairly
8 compensate shareholders for their invested capital.

9 **Q. WILL DE-OHIO'S CUSTOMERS BENEFIT IF DE-OHIO IS ABLE TO**
10 **ACHIEVE ITS FINANCIAL OBJECTIVES?**

11 A. Yes, our customers will benefit from the financial objectives that we have
12 established. As previously discussed, maintaining a strong capital structure with a
13 sufficient return on equity helps to ensure safer returns to debt holders, which
14 translates into higher credit quality, allowing DE-Ohio the financial flexibility to
15 attract capital from the debt and equity markets as needed. The benefits of these
16 financial objectives include not only lower debt financing costs, but also greater
17 assurance of access to the capital markets as needed, thus improving DE-Ohio's
18 ability to maintain a safe, reliable, and low cost level of customer service for its
19 customers.

VI. SCHEDULES AND FILING REQUIREMENTS **SPONSORED BY WITNESS**

20 **Q. PLEASE DESCRIBE SUPPLEMENTAL FILING REQUIREMENT (C)(3).**

21 A. Supplemental Filing Requirement (C)(3) is a copy of the prospectus from the most

1 recent common stock offering and bond offering.

2 **Q. PLEASE DESCRIBE SCHEDULES D-1A AND D-1B.**

3 A. Schedule D-1A is a summary showing the calculation of the rate of return on rate
4 base being proposed in this case for DE-Ohio. Schedule D-1B is a similar summary
5 of the rate of return using Duke Energy's capital structure. I sponsor the
6 information being used for the calculation of the debt component and Dr. Morin
7 provided the rate of return on equity.

8 **Q. PLEASE DESCRIBE SCHEDULES D-2A AND D-2B.**

9 A. Schedule D-2A provides details about the short-term debt position for DE-Ohio as
10 of March 31, 2008. Schedule D-2B provides details about the short-term debt
11 position for Duke Energy as of March 31, 2008.

12 **Q. PLEASE DESCRIBE SCHEDULES D-3A AND D-3B.**

13 A. Schedule D-3A provides the details about the long-term debt position and cost of
14 DE-Ohio's long-term debt as of March 31, 2008, which were used to calculate the
15 rate of return. Schedule D-3B provides details about the long-term debt position and
16 cost of long-term debt for Duke Energy as of March 31, 2008.

17 **Q. PLEASE DESCRIBE SCHEDULES D-4A AND D-4B.**

18 A. Schedule D-4A is used to provide the cost of preferred stock used to calculate the
19 rate of return; however, this schedule is submitted in blank form because DE-Ohio
20 does not have preferred stock. Schedule D-4B provides similar information for
21 Duke Energy and, like DE-Ohio, there is no preferred stock outstanding.

VII. CONCLUSION

1 **Q. WERE AND THE SUPPLEMENTAL FILING REQUIREMENT AND THE**
2 **SCHEDULES YOU SPONSOR PREPARED BY YOU OR UNDER YOUR**
3 **SUPERVISION?**

4 **A. Yes.**

5 **Q. IS THE INFORMATION YOU SPONSORED IN SUPPLEMENTAL**
6 **FILING REQUIREMENT (C)(3) AND SCHEDULES D-1A, D-1B, D-2A, D-**
7 **2B, D-3A, D-3B, D-4A, and D-4B ACCURATE TO THE BEST OF YOUR**
8 **KNOWLEDGE AND BELIEF?**

9 **A. Yes.**

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

11 **A. Yes.**